

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

**Compendium of Legislative Proposals
Simplification and Technical Proposals**

**Approved by the
Tax Executive Committee**

February 2013

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FOREWORD

The American Institute of Certified Public Accountants (AICPA) is actively pursuing or has published positions on a number of major legislative proposals regarding such important matters as the due dates of tax returns, a uniform standard among states for taxation and withholding for nonresidents, repeal of the alternative minimum tax and comprehensive tax and penalty reform. Our focus in this Compendium of Legislative Proposals, however, is on provisions in the Internal Revenue Code that need attention, are technical in nature, and perhaps can be more readily resolved. It is intended to aid in the development of federal tax legislation in directions that the AICPA believes are in the public interest.

While we intend to continue to submit comments and proposals on major issues in reform efforts, we have asked AICPA Tax Division committees to make recommendations for legislative proposals that correct perceived technical problems in the Code or that would simplify its existing provisions. It is intended that these proposals not be unduly controversial, but instead promote simplicity and fairness. The enclosed proposals were among those proposals received in response to that request. We intend to continue our efforts in this area and make further recommendations in the future.

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Proposal: Repeal full vesting on partial termination of qualified retirement plans

Present Law

Section 411(d)(3) of the Internal Revenue Code (IRC or “Code”) requires qualified retirement plans to provide for full vesting upon partial plan termination. It was added by section 1012 of the Employee Retirement Income Security Act of 1974 (ERISA) and has not been amended since. The Code does not define “partial termination.” The regulations provide that whether a partial termination occurs shall be determined by the Commissioner with regard to all the facts and circumstances in a particular case. Treas. Reg. § 1.411(d)-2(b)(1).

Description of Proposal

Repeal the requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan.

Analysis

The partial termination rules impose significant administrative burdens due to the uncertainty of whether and when a partial termination occurs. Moreover, the benefit to participants of full vesting upon partial termination has diminished over time. The vesting schedule requirements applicable to qualified retirement plans have been greatly accelerated since ERISA was enacted. Section 411(a) originally required either 10-year cliff or 5- to 15-year graded vesting. ERISA, section 1012. The current section 411(a) requirement is 5-year cliff or 3- to 7-year graded vesting.

Conclusion/Recommendation

The requirement under section 411(d)(3) that benefits become fully vested upon a partial termination of a qualified retirement plan should be repealed to reduce employers’ administrative burdens without significantly affecting employees.

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Proposal: Harmonize and simplify education-related tax provisions

Present Law

Included in the Internal Revenue Code are education incentives that may be divided into two general categories: (1) those that are intended to help taxpayers meet current higher education expenses and (2) those that encourage taxpayers to save for future higher education expenses.

The first category includes provisions that may be 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 Hope Credit (for tax years 2009 through 2012, referred to as the American Opportunity Tax Credit) and Lifetime Learning Credit (section 25A).

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).

The various provisions contain numerous and differing eligibility rules summarized in the accompanying tables.

Description of Proposal

Tax benefits for higher education should be simplified and harmonized.¹ Specifically, we recommend the following provisions:

1. Replace tax incentives (i.e., Hope Credit, American Opportunity Tax Credit, Lifetime Learning Credit and the tuition and fees deduction) intended to help taxpayers meet current higher education expenses with one new or revised credit. Combining features of these into one credit would simplify the tax benefits and remove duplicative provisions relating to higher education expenses.
 - a. The credit should be on a “per student” rather than a “per taxpayer” basis, offering a potentially larger tax benefit per family.
 - b. The credit should be available for any year of post-secondary education, including graduate-level and professional degree courses.
 - c. The credit should be 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) of the student associated with the expenses claimed with respect to

¹ The AICPA submitted [testimony](#) to the Senate Finance Committee hearing on Education Tax Incentives and Tax Reform on July 25, 2012.

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- the credit taken for the tax year. Accordingly, amounts claimed over time could be tracked by the student's SSN. These changes may result in improved compliance and enforcement.
- f. The credit should be 100% refundable and phased out for high-income taxpayers. The phase-out limitations should be consistent with any other education-related incentive.
 - g. The credit should be claimed on the parent's return as long as the child is a qualifying dependent of the parent.
2. 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. Also, the terms "special needs services" and "special needs beneficiary" should be clearly defined.
 3. Coordinate the phase-out amounts for the student loan interest deduction and the educational savings bonds and Coverdell Education Savings Accounts exclusions with the new or revised tax credit intended to help taxpayers meet current higher education expenses. All education-related tax provisions should have the same AGI limitations. The concern for excessively high marginal rates resulting from coordinating phase-out provisions should be alleviated by substituting one credit for the several benefits that exist today. In addition, any remaining concerns could be addressed by widening the phase-out range, which would still permit coordination that could simplify matters for taxpayers and improve their understanding of eligibility.

Analysis

For many taxpayers, analysis and application of the intended incentives are too cumbersome compared with the benefits received. The Government Accountability Office (GAO) analyzed 2009 data for tax returns with information on education expenses and found that about 14 percent of filers (1.5 million of nearly 11 million eligible taxpayers) failed to claim a credit or deduction in which they were eligible. On average, these filers lost a tax benefit of \$466 (GAO 12-560 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 would be most advantageous to them. Finally, there is evidence that the regressive nature of the provisions prevents low-income taxpayers from getting the tax benefit that Congress envisioned.

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, 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

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“the complexity of the education tax incentives increases record-keeping 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 adjusted gross income level of the parents (or possibly the student). Further, in a given year, a parent may be entitled to different credits for different children, while in subsequent years credits may be 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 Hope (American Opportunity Tax) Credit if the child also receives tax benefits from an education savings accounts. Although the child can elect out of such benefits, this decision also entails additional analysis.

An additional complicating factor is the phase-out of eligibility based on various AGI levels in six of the nine provisions. This requires taxpayers to make numerous calculations to determine eligibility for the various incentives. Since there are so many individual tests that must be satisfied for each benefit, taxpayers may inadvertently lose the benefits of a particular incentive 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 is making a significant contribution to the “Tax Gap.” A report issued by the Treasury Inspector General for Tax Administration (TIGTA) in 2011 states that education credits of approximately \$3.2 billion (\$1.6 billion in refundable credits and \$1.6 billion in nonrefundable credits) appear to be erroneous.² Over four years, erroneous education credits could potentially reach \$12.8 billion.³

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. The current tax provisions do not always meet the goal of helping low- to middle-income families with college expenses. Consideration should be given to where assistance can best be 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). Consideration should also be given to identifying the targeted income group to whom the federal government should be providing financial assistance for higher education expenses. When assessing whether

² Treasury Inspector General for Tax Administration Report 2011-41-083, Billions of Dollars in Education Credits Appear to Be Erroneous (September 16, 2011).

³ *Id.*

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this goal is met, aid distributed through scholarships, grants or tax provisions should be considered.

Conclusion/Recommendation

Education-related tax provisions should be simplified as suggested above so that taxpayers better understand the rules and can both claim and 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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Education Incentives – Exclusions and Deductions				
Code §	Provision	Summary	Qualified Education Expenses Defined As	AGI Phase-Out
Exclusions				
117	Exclusion for scholarships	Excludes scholarship from income to the extent it covers qualified education expenses for degree-seeking undergraduate student	Tuition, books, supplies, 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, equipment; but not room and board Does not have to be for work-related courses	None
Deductions				
221	Student loan interest deduction	For AGI deduction of \$2,500 for interest paid on qualifying student loan	Tuition, fees, books, supplies, equipment, room and board, transportation, other necessary expenses	S: \$60,000 - \$75,000 MAGI MFJ: \$125,000 - \$155,000 MAGI MFS: No deduction
222	Qualified tuition and fees deduction (expires 12/31/13)	For AGI deduction of up to \$4,000	Tuition, fees; but not room and board Student-activity fees and expenses for course-related books, supplies, and equipment are included in QHEE only if the fees and expenses must be paid to the institution as a condition of enrollment	S, HOH: If AGI is not more than \$65,000, may deduct \$4,000; if between \$65,000 and \$80,000, may deduct \$2,000 MFJ: If AGI is not more than \$130,000, may deduct \$4,000; if between \$130,000 and \$160,000, may deduct \$2,000 MFS: No deduction

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Education Incentives – Credits				
Code §	Provision	Summary	Qualified Education Expenses Defined As	AGI Phase-Out
25A	American Opportunity Tax Credit (for tax years 2009 through 2017)/Hope credit	<p>Credit of up to \$2,500 per student: 100% of first \$2,000; 25% of next \$2,000</p> <p>Must be enrolled at least half-time</p> <p>40 percent of modified credit is refundable (but not for child subject to section 1(g) Kiddie Tax)</p> <p>If parent pays the expenses, must be able to claim exemption for 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 be associated 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>
25A	Lifetime Learning Credit	<p>Credit of up to \$2,000 per return: 20% on up to \$10,000</p> <p>A non-refundable elective credit</p> <p>If parent pays the expenses, must be able to claim exemption for student on tax return</p> <p>Regulations explain who gets credit in special circumstances</p>	<p>Tuition and fees including for graduate courses/continuing education; but not room and board</p> <p>Available for all post secondary education—not necessarily associated with degree</p>	<p>S: \$52,000 - \$62,000</p> <p>MFJ: \$104,000 - \$124,000</p> <p>MFS: No credit</p>

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Education Incentives – Planning for College				
Code §	Provision	Summary	Qualified Education Expenses Defined As	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: \$74,700 - \$89,700 for MFJ: \$112,050 - \$142,050 MFS: No exclusion
529	Qualified Tuition Plans	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 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 Contributions qualify for the annual gift tax exclusion Earnings are not taxed and funds may be withdrawn tax free if used for qualifying purposes	Tuition and fees, books, computers, technology and other expenses for vocational schools, 2-year and 4-year colleges 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	None
530	Coverdell Education Savings Account	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 assets must be withdrawn by age 30 Distributions non-taxable to extent funds used for QHEE or qualified elementary and secondary education expenses	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	S: \$95,000 and \$110,000 MFJ: \$190,000 and \$220,000 MFS: \$95,000 and \$110,000

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Proposal: Standardize the allowable mileage rates for business expense, medical expense and charitable contribution purposes

Present Law

A standard mileage allowance, generally determined annually, is allowed to taxpayers in determining their expenses related to employment (56.5 cents per mile beginning January 1, 2013). Further, a standard mileage allowance, also generally determined annually, is allowed to taxpayers for purposes of medical and moving expense deductions (24 cents per mile beginning January 1, 2013). When necessary, the IRS has the authority to adjust these rates at any time (as they did in mid-year 2011 to reflect the extraordinary rise in gasoline prices). In contrast, the mileage rate allowed for charitable contribution deduction purposes is set by law at 14 cents a mile. Prior to 1984, the IRS had the authority to set this rate as well.

Note: Legislation (H.R. 6854 and S. 3246) was introduced in the 110th 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. Separate legislation (S.3429) also was introduced in the 110th Congress to set the charitable deduction mileage rate at 70% of the business mileage rate. In the 111th Congress, three bills (H.R.345, H.R.590, and S. 285) were introduced to set the charitable contribution mileage deduction rate at the same amount as that allowed for business expenses.

Description of Proposal

Allow two mileage rates: one for business expenses and another for all non-business purposes (charitable, medical and moving expenses). The non-business rate should be set by the IRS at a percentage of the business rate, rounded to the nearest half cent. The business rate should be adjusted annually and possibly semi-annually in certain circumstances. The starting point would be the business rate in effect at the time of enactment.

Analysis

Currently, taxpayers often need to apply at least two and sometimes three different mileage rates on a single return. The proposal would reduce these numbers to one and occasionally two rates per return. Allowing the Internal Revenue Service (IRS or “Service”) to set a fair rate for charitable contribution mileage would recognize the vital role volunteers play in our society. Linking all mileage rate allowances to a single standard and adjusting those rates at least annually would bring fairness and equity to the process. In addition, the IRS’s annual calculation of these rates would be simplified.

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Conclusion/Recommendation

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

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Proposal: Allow certain attorney fees and court costs as deductions for AGI

Present Law

In computing adjusted gross income (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 Internal Revenue Code. As such, these expenses are 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. In addition, miscellaneous itemized deductions are not deductible in computing alternative minimum tax (AMT). 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 (PL 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 US Code Title 31; and
- Claim under § 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 (PL 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

Section 62 should be modified to allow a deduction for AGI for any attorney fees and court costs paid or incurred by a taxpayer related to any litigation award or settlement that is included in gross income.

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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:⁴

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 Internal Revenue Service. 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 be permitted 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 one percent 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 Internal Revenue Service 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 supportable. The reason for

⁴ Tax Reform Act of 1986 (PL 99-514; 10/22/86), House explanation.

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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 did so 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.

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 be broadened to include all attorney fees and court costs that relate to taxable awards.

Conclusion/Recommendation

Section 62(a)(20) and (21) should be replaced 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: Clarify and simplify reporting of cancellation of debt income

Present Law

Under Treas. Reg. § 1.6050P-1, an entity that discharges a debt to any person of at least \$600 during a year, must file a Form 1099-C. For these purposes, a discharge of indebtedness is deemed to occur when an identifiable event occurs whether or not an actual discharge of indebtedness has occurred on or before the date of the identifiable event.

Description of Proposal

The AICPA proposes that section 6050P, returns relating to the cancellation of indebtedness by certain entities, should be modified to provide that Form 1099-C should be issued only if the borrower's legal obligation to repay has been terminated.

Analysis

Frequently taxpayers who believe they have settled a debt, foreclosure or bankruptcy issue receive a Form 1099-C from the bank or other institution and are unaware that the unpaid debt issue has been forwarded to a collection organization that begins a process of seeking to negotiate or collect as much as they can.

Unaware of their legal rights or obligations, the taxpayers are understandably confused and do not recognize that the receipt of this IRS form does not have any bearing on these collection efforts nor are these collection efforts constrained if the taxpayer produces these forms.

Conclusion/Recommendation

We recommend that borrowers should not be issued a Form 1099-C unless their legal obligation to repay a loan has been terminated.

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Proposal: Provide parity 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 the cost of 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. 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 be consistent amongst 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

It is recommended that deductions allowed in determining income subject to OASDI and HI taxes be consistent amongst taxpayers regardless of whether they are employees or self-employed individuals.

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Proposal: Remove reference to section 332 from section 367(a)(i)

Present Law

Section 367(a)(1) of the Internal Revenue Code states, “if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.”

Description of Proposal

We recommend that Congress remove the reference to section 332 from section 367(a)(1), since it is no longer relevant.

Analysis

The reference to section 332 as currently included in the language of section 367(a)(1) is no longer needed, since the effects of section 332 liquidations as they relate to foreign corporations are addressed in section 367(e)(2).

Conclusion/Recommendation

Since the reference to section 332 in section 367(a)(1) is no longer relevant, it should be removed to simplify the Internal Revenue Code.

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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 Internal Revenue Code. 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 a penalty, but only in the case of transactions other than listed transactions, where rescinding the penalty would promote efficient 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). 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 proper. 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 shall be 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 shall be imposed 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.

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Analysis

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

Moreover, we believe the absence of judicial review when the Service has assessed a penalty 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. We believe that 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.

Conclusion/Recommendation

Section 6707A should be amended to allow an exception to the penalty if there was reasonable cause for the failure 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, section 6664 should be amended to provide a general reasonable cause exception, 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 the section 7122(c)(1) requirement to provide a 20% partial payment with a lump-sum offer in compromise

Present Law

Under section 7122(c)(1) of the Internal Revenue Code, if a taxpayer submits a lump-sum offer in compromise (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 of 20 % of the offer amount to the Service upon submission of the offer application. Low-income taxpayers (persons with incomes below 250% of the federal poverty thresholds) 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

Resolving outstanding tax liabilities efficiently is necessary for good tax administration and reduction of the tax gap. The IRS should have the opportunity to review offers and determine whether accepting an offer is in the best interest of the government. The IRS should use offers in compromise as one of the many tools to collect the proper amount of tax. However, the 20% requirement of 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, in about 70% of the offers accepted by the IRS prior to implementation of section 7122(c)(1), the 20% payment amount was not available from the taxpayer's liquid assets. 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, unfortunately, family and friends of the taxpayer may be reluctant to provide the taxpayer with the necessary funds for the partial payment amount, particularly when informed that the payment amount is nonrefundable, even when the offer is not otherwise accepted later (creating a situation that could be construed as a barrier to settling tax debts for many taxpayers).

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 real effect of the 20% requirement is to discourage the submission of a large number of legitimate offers.

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Conclusion/Recommendation

Repeal of section 7122(c)(1) will provide taxpayers with an effective option for addressing a federal tax liability, particularly during the current period of economic downturn.

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Proposal: Allow transfer of partnership suspended losses to one another when spousal transfers under section 1041(a) take place

Present Law

Section 1366(d)(2)(B) of the Internal Revenue Code permits an S corporation shareholder to transfer 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 suspended losses of partners in partnerships.

Description of Proposal

Husbands and wives engaged together in the operation of a partnership may transfer partnership units to each other under section 1041(a) or incident to a divorce. When such a transfer occurs, suspended losses of the transferor spouse will now be treated as incurred by the partnership in the succeeding taxable year with respect to the transferee spouse.

Analysis

Spouses and former spouses who transfer partnership interests between themselves find that they are in the same position in which husband and wife 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, forever unusable.

Conclusion/Recommendation

Suspended losses should be made available to the spouse who actually owns the partnership interest, regardless of who was entitled to the suspended loss prior to the transfer of ownership interest. This recommendation furthers the tax policy goals of simplicity and equity.

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Proposal: Clarify that husband and wife 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 husband and wife partnership by treating it as two sole proprietorships. The only statutory requirements are that (1) the husband and wife both 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 not to be treated as a partnership.

On its website, the IRS has published a definition of a Qualified Joint Venture under 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 husband and wife joint venture election under section 761(f) should be clarified to cover state law general and limited partnerships and limited liability companies. To accomplish this result, a modification to section 761(f)(2) could be made 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.

Analysis

The administrative limitation on state law entities makes it hard to imagine which, if any, husband-wife partnerships are able to take advantage of this potential simplification. The state law rules governing partnerships and limited liability companies are typically based on the Revised Uniform Partnership Act, the Revised Uniform Limited Partnership Act or the Uniform Limited Liability Company Act as adopted by a particular state but which typically defines a partnership as two persons engaged in an activity for profit and treats even a general partnership as a state law entity. Such a definition would bring virtually all husband and wife business operations under state law jurisdiction and would thus disqualify them from electing QJV status.

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Conclusion/Recommendations

Congressional clarification of section 761(f) is needed. If Congress would like to achieve the simplification it contemplated when it enacted this election, it must specifically allow husband and wife partnerships (including the popular limited liability company, but minimally the general partnership) to make this election.

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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 year

Present Law

Generally, section 1371(b) prohibits the carryover of deductions and credits from a C year to an S year. However, sections 1374(b)(2) and (b)(3)(B) allow certain exceptions so that net operating loss and capital loss carryforwards, as well as section 39 general business and section 53 minimum tax credit carryforwards from C years are permitted to offset the net recognized built-in gain of an S corporation. No such deduction from or credit against the net unrecognized built-in gain of an S corporation is permitted for charitable contribution or foreign tax credit carryforwards.

Description of Proposal

Section 1374(b)(2) would be modified to add charitable contribution carryforwards from a C year to the items that can be deducted against the net recognized built-in gain of an S corporation.

Section 1374(b)(3)(B) would be modified to add section 27 foreign and possessions tax credit carryforwards to the items allowed as a credit against the net recognized built-in gain of an S corporation. An alternative way to achieve the same result is to modify section 39(b) to include the foreign tax and possession tax credits among the current year general business credits permitted to be carried forward from a C year to an S year.

Analysis

It would seem equitable that all deduction and credit carryforwards arising in a C year be allowed to reduce the corporate-level built-in gain tax of an S corporation since both the carryforwards and the BIG tax relates to a liability integrally related to the former C corporation. It appears that the foreign credits may have been omitted simply as an oversight due to their lack of inclusion in the general business credit regime.

Conclusion/Recommendation

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.

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Proposal: Add a new 120-day Post-Termination Transition Period (PTTP) beginning on the date that a taxpayer files an amended Form 1120S

Present Law

Section 1377(b) defines a post-termination transition period in one of three ways, each of which occurs after a termination of the S election. The first PTTP begins the day after the last S year ends and ends the later of one year or the extended due date of the return. The second period begins on the date an IRS adjustment is made and lasts for 120 days. The third period begins on the date an IRS determination is made that the S election had terminated for a previous year and lasts for 120 days. Sections 1366(d)(3) and 1371(e) describe the major benefits of the PTTP as allowing a shareholder to adjust stock basis, utilize suspended losses and take tax-free distributions to the extent of both AAA and basis through the end of the PTTP as though the S corporation election were still valid.

Description of Proposal

A fourth PTTP would be added such that a 120-day PTTP would begin on the date that an amended return (Form 1120S) is filed if (1) the filing occurs after the S period ends; (2) if such 120-day period would lengthen the initial [generally] one-year PTTP and (3) if the amended return adjusts any item of income, loss or deduction arising during the S period. This new PTTP would be accomplished by the addition of new subparagraph 1377(b)(1)(D) as follows:

- (D) the 120-day period beginning on the date an amended return has been filed for any S year, having been so filed after the termination of the corporation's election, and which amended return adjusts a subchapter S item of income, loss, or deduction of the corporation arising during the S period (as defined in section 1368(e)(2)).

Conforming amendments would be made to subparagraphs (A) and (B) of section 1377(b)(3) by replacing the language "Paragraph (1)(B)" with "Paragraphs (1)(B) and (D)" each place it appears. In addition, the heading for section 1377(b)(3) would be modified to read "Special rules for audit and amended return related post-termination transition periods."

Analysis

We believe the source of adjustments to S items, whether by IRS audit or by the taxpayer, should be immaterial when it comes to obtaining the benefits of a PTTP. When a tax return is corrected because of taxpayer oversight, error, judicial clarification, or another reason, the corrected return should be the basis for determining AAA, the taxability of distributions, shareholder basis and other items that are relevant during the PTTP and, therefore, the filing of an amended return should also trigger the beginning of a new PTTP, as occurs in the case of an audit adjustment.

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Conclusion/Recommendation

The reason for adjustments to S items, whether by audit or taxpayer redetermination on an amended Form 1120S, is immaterial to the policy behind a PTTP. Accordingly, a 120-day PTTP should begin upon the filing of an amended Form 1120S.

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Proposal: Allow S corporations to have nonresident aliens as shareholders and potential current beneficiaries of electing small business trusts

Present Law

Section 1361(b)(1)(C) of the Internal Revenue Code provides that a nonresident alien is not eligible to be a shareholder of an S corporation. Reg. section 1.1361-1(m)(1)(ii)(D) and -1(m)(5)(iii) require that a potential current beneficiary (PCB) of an electing small business trust (ESBT) must be an eligible S corporation shareholder. Thus under current statute, nonresident aliens are not permitted shareholders and under current regulations, they are not permitted PCBs. If a nonresident alien becomes a PCB of an ESBT, the S corporation's election will terminate.

Description of Proposal

Allow nonresident aliens to be shareholders of an S corporation and require the S corporation to withhold and pay a withholding tax for its nonresident alien shareholders. Also permit nonresident aliens to become PCBs of an ESBT.

Analysis

Nonresident aliens should be allowed as shareholders and as potential current beneficiaries of electing small business trusts. 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 such result can be obtained and is willing and able to pay a professional to restructure the operations of the S corporation through partnerships; the operating partnerships, in turn, permit nonresident aliens to hold ownership interests and thus nonresident aliens indirectly receive passthrough items from the S corporation's operations. If nonresident aliens were permitted to be direct owners of S corporations, they would be subject to withholding just as nonresident alien partners are, thus protecting against revenue loss at the individual level. Such direct ownership benefits should not be available only to the sophisticated taxpayer. The smaller, struggling S corporations, particularly those in border states, should also be free to raise capital from these individuals.

With regard to nonresident aliens as PCBs of an ESBT, because the trust pays tax at the highest rates, there is no policy reason for restrictions on the types of allowable ESBT potential current beneficiaries.

Conclusion/Recommendation

Section 1361(b) should be amended to allow a nonresident alien to be an eligible shareholder of an S corporation. In conformity with that change, section 1446 should be amended to require the S corporation to withhold and pay a withholding tax on effectively connected income allocable to the corporation's nonresident alien

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shareholders. A nonresident alien should also be a permitted potential current beneficiary of an electing small business trust.

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

Present Law

Section 1375 imposes the highest corporate rate of tax (currently 35%) on the royalties, rents, dividends, interest and annuities earned by certain S corporations if such revenue sources, net of allowable deductions, exceed 25% of the corporation's gross receipts and if the corporation has accumulated earnings and profits from a former C year at the close of the tax year. There are exceptions to this rule for certain income of banks and bank holding companies, finance companies, interest from installment sales of inventory and dividends from certain C corporation stock. An S corporation may avoid the tax by distributing its AE&P before the close of the tax year.

Section 1362(d) penalizes an S corporation with involuntary termination of its S election if the tax under section 1375 is imposed for three consecutive years.

Description of Proposals

Eliminating the termination event

Section 1362(d)(3) should be repealed in its entirety, thus preventing the threat of an involuntary termination of the S election related to passive investment income.

Raising the PII thresholds

Sections 1375(a)(2) and (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) would be modified to replace "25%" with "60%" each place it appears. This change would have the effect of raising the threshold for the imposition of the tax on excess net passive investment income.

Analysis

The apparent, although unstated, goal of the excess net passive investment income tax and termination of the S election is to penalize an S corporation for a failure to distribute the accumulated earnings and profits 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 tax is intended to encourage distributions of C corporate earnings and profits, then why not tax the earnings and profits under a concept similar to the accumulated earnings tax of sections 531-537? We recommend that Congress draft a similar regime that is appropriate under subchapter S. If the current regime is to be maintained, it should at least minimize the differential

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between a hypothetical, yet correlated tax on accumulated earnings and profits and the uncorrelated tax currently imposed on excess net PII.

While encouraging distributions of accumulated earnings and profits appears to be the primary goal of sections 1375 and 1362(d)(3), a logical by-product of the sting tax regime is to discourage the earning of passive investment income by S corporations since the tax is, in fact, imposed on and triggers a termination based on PII. However, it is impossible that discouraging an S corporation from earning PII was the sole goal of the original lawmakers since the regime only applies to S corporations with accumulated earnings and profits. Accordingly, as a matter of fairness, and to better fit the “punishment” with the “crime,” the termination event should be repealed or made to impact fewer taxpayers. These measures would be a positive first step.

Conclusion/Recommendation

Section 1362(d)(3) should be repealed to eliminate a significant uncertainty for S corporation operations, thereby preventing an involuntary termination of S status caused by excess passive investment income. If repealing section 1362(d)(3) is not feasible, Congress should eliminate the impact of the “sting tax” by modifying sections 1362(d)(3) and 1375 and replace “25 percent” with “60 percent” each time it appears, thereby taxing an S corporation’s passive investment income in an analogous fashion to imposition of the personal holding company tax on C corporations. Enactment of either measure would enable an S corporation to earn large amounts of passive investment income without loss of its S status or fear of a corporate tax.

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Proposal: Allow administrative relief for certain late QTIP and QRT 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.

QTIP election

Transfers of property interests that meet the requirements to be a 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 must be made by the decedent’s executor on the Federal estate tax return. For an inter vivos QTIP transfer, the QTIP election must be 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 shall be made on or before the date prescribed by section 6075(b) for filing a gift tax return with respect to the transfer. Because 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.

QRT election

Effective with respect to estates of decedents who die after August 5, 1997, an election may be made 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

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treat a QRT as part of the decedent's estate shall be made not later than the time prescribed for filing the return of tax imposed 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, we believe that the IRS would take the position that it does not have the authority to grant relief for late elections. Decedent's estates that do not make the election timely have no recourse to cure the problem and are disadvantaged because of the errors committed by their tax advisors.

Description of Proposal

The IRS should be authorized to grant Section 9100 Relief for certain late or defective lifetime (i.e., inter vivos) QTIP elections and for late elections by certain QRTs to be treated as part of a decedent's estate. This could be accomplished by revising the IRC to provide that the due dates for the inter vivos QTIP election and for the QRT election to be part of the estate are treated as if not prescribed by statute. These proposals would make the same sort of statutory change in section 2523(f)(4) and section 645(c) as was done by Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) in section 2642(g)(1)(B) (and extended through 2012 by the 2010 Act), so that taxpayers would not be penalized for the errors of their tax advisors and tax return preparers in failing to make a QTIP election on the Federal gift tax return or a QRT election to be part of an estate on the estate's first Federal income tax return. 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 (GST) exemption relief in EGTRRA.

Analysis

The problems for late QTIP and QRT elections are similar to the problem that existed with the allocation of GST exemption prior to EGTRRA. There, 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 whether to grant relief under this paragraph, the time for making the allocation (or election) shall be treated as if not expressly prescribed by statute." That language opened up the possibility of section 9100 relief for failed allocations of GST exemption. Given that statutory authority, the IRS has granted 9100 relief in hundreds of cases.

We note that legislation to provide administrative relief for inter vivos QTIP elections has been introduced previously and was even reported by the Senate. Specifically, in the 109th 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-](#)

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[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.

This gift tax relief is important because it would extend to the gift tax the same relief that is available for errors on estate tax returns concerning the identical issue. In addition, 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 be of minimal cost (estimated in 2006 at \$2 million over 10 years per [JCX-29-06](#)). 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, so we expect this proposal as well would be of minimal cost.

Conclusion/Recommendation

We urge the enactment of legislative provisions stating that the due dates for the inter vivos QTIP election and for the QRT election to be part of the estate are treated as if not prescribed by statute, thus allowing the IRS to grant administrative relief for certain late QTIP and QRT elections.⁵

⁵ The AICPA submitted a [letter](#) requesting legislation permitting administrative relief for certain late lifetime qualified terminable interest property elections and certain late qualified revocable trust elections on November 16, 2010.

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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 very confusing and unnecessarily complex to taxpayers and tax practitioners. In some instances, estimated tax payments may be allocated by the fiduciary 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. Regular withholding may not be allocated to the beneficiary, but must be reported by the trust or estate even if its 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 IRC section 643(g) to have any part of its estimated tax payments allocated to beneficiaries. The fiduciary makes this election by filing [Form 1041-T](#), Allocation of Estimated Tax Payments to Beneficiaries, by the 65th day (i.e., generally March 5 for calendar year taxpayers) after the close of the tax year. Absent a timely election, the estimated tax payments are reported by the trust or estate on its [Form 1041](#), U.S. Income Tax Return for Estates and Trusts, and cannot be allocated to beneficiaries on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc.

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

For regular withholding, the credit under IRC section 31(a) for amounts withheld as tax under chapter 24 (regular withholding) may not be allocated by the trust or estate to a beneficiary. See [Chief Counsel Advice 200644018](#) (Dec. 25, 2005), in which the Internal Revenue Service 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 can be used 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 be passed through to beneficiaries on either Schedule K-1 or Form 1041-T.

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Description of Proposal

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

With respect to regular withholding, the title of section 643(d) could be changed to "Coordination with withholding" and section 643(d)(1) could be amended to include a reference to section 31(a) so that it would 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 estates be added to the general rule of section 643(g)(1) with the result that section 643(g)(3) would be repealed and that amendments be made to 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's tax payments to be treated as paid by estate beneficiaries in years other than just the estate's last tax year if the executor so chooses. We believe these proposals will simplify processing for the IRS as well as taxpayers. We think that any revenue cost for this proposal would be negligible as it only deals with allocating tax payments 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 great 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 65th 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 46th day of the next year and many Forms 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.

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 must be refunded to the fiduciary. Regular withholding payments must always be 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 so has no way to cash the check or make a further distribution.

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 can be applied only to a later year's tax or refunded to the fiduciary.

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.⁶

Present Law

The current law denies a deduction for the cost of complying with many fiduciary duties to the extent that their aggregate cost does not exceed 2-percent of the taxpayer's adjusted gross income. This is known as the "2-percent floor."

By way of background, Congress enacted section 67(a) in 1986 to limit deductions for miscellaneous itemized deductions to those in excess of 2 percent of adjusted gross income (AGI). Congress's purpose was to reduce recordkeeping for numerous small expenditures and eliminate deductions for many, essentially personal expenditures claimed in error.⁷ Because estates and nongrantor trusts⁸ are taxed in the same manner as individuals, Congress provided an exception to the 2-percent 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 numerous 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](#) section 1.67-4. On September 7, 2011, the IRS withdrew those regulations and issued a replacement set of [proposed regulations](#) section 1.67-4 attempting to implement the Supreme Court's decision. The proposed regulations require trustees' fees and other single commission fees to be unbundled and separated between costs that are commonly incurred by individuals and those that are not. The IRS and Treasury have been unsuccessful in drafting regulations that are clear and administrable, without subjecting nearly all administrative costs to the 2-percent floor. Doing so eliminates the exemption under

⁶ The AICPA submitted a similar proposal on [September 8, 2008](#) to the 110th Congress.

⁷ [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.

⁸ 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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section 67(e). Expressing similar frustration over section 67(e), Chief Justice Roberts commented:

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. We think the proposed amendment below would simplify the statute, would modernize it for the prudent investor rule,⁹ make it easier to administer, and provide a consistent definition of AGI for estates and nongrantor trusts throughout the Internal Revenue Code. We do not think the proposal would encourage individuals to create nongrantor trusts to merely avoid the 2-percent floor. The associated costs of creating such trusts would likely exceed any tax benefit. Creating a separate trust requires giving the money away, not to mention the extra management cost and liability associated with creating a separate legal entity.

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 his/her fees into the portion an individual would have incurred (subject to the 2-percent floor) and the portion that is fully deductible. The proposed regulations indicate “any reasonable method” is to be used for the determination. Such recordkeeping complexity is contrary to sound tax policy.

⁹ 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.

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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 predicting whether individuals would commonly incur a particular expense that the trust or estate incurred, it will result in uncertainty, inconsistent treatment from trust to trust, errors of judgment, and potential penalties on both the trustee and tax preparers.
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. Thus, the Internal Revenue Code 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 will be 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 Internal Revenue Code and other regulatory acts.
6. Trusts are small taxpayers. According to IRS Statistics of Income for 2010, over 96% of all trusts report less than \$100,000 of total income, including capital gains.¹⁰ 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 Internal Revenue Code should reflect that estates and trusts are generally small taxpayers burdened with mandatory duties that require extra costs to administer.
7. 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

¹⁰ Table 1. Fiduciary Income Tax Returns, Income Source, Deductions, and Tax Liability, by Tax Status and Size of Total Income, Filing Year 2010, *available at* <http://www.irs.gov/taxstats/article/0,,id=225290,00.html>.

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which costs would not customarily be incurred by a hypothetical individual in order to determine the costs not subject to the 2-percent 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-percent 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 will likely be 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.

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 would be 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 Internal Revenue Code’s denial of a full deduction for the costs of complying with the Act.
9. Trustees are already heavily regulated. 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 be loyal and impartial, 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 Internal Revenue Code. The Internal Revenue Code 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 Internal Revenue Code should be simplified to provide a single definition of AGI for estates and trusts, which should be the definition contained in section 165(h)(4)(C).

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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 from the filing requirement of section 6034(a) trusts with charitable deductions only from flow-through entities

Present Law

The AICPA continues 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 exempt from complying with the information reporting requirements of Internal Revenue Code section 6034(b)(1) trusts whose only charitable deductions are passed through to them from a flow-through entity (e.g., an S corporation, limited liability company (LLC), or partnership).

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

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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 regulations¹¹; a charitable trust described in section 4947(a)(1)¹²; and for tax years beginning after 2006, a split-interest trust described in section 4947(a)(2).¹³ 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 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.

Analysis

Often trusts invest in partnerships 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 Internal Revenue Service 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.

A similar situation arises with respect to electing small business trusts (ESBTs) that own stock in an S corporation if the S corporation makes a contribution to charity from its gross income. Treasury Reg. § 1.641(c)-1(d)(2)(ii) provides that if an ESBT is required to take into account a deduction attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose, the contribution will be deemed to be paid by the S portion of the ESBT pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1).

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

¹¹ See section 6034(b)(2)(A).

¹² See section 6034(b)(2)(B).

¹³ See section 6034(a).

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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 Internal Revenue Service. 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, LLC, or S corporation 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. We believe that an exception should be created for these trusts because charitable deductions passed through to trusts from partnerships, LLCs, or S corporations do not appear to fall within the scope and purpose of the information reporting requirement of section 6034(b).

Description of the Proposal

We suggest that an additional exception (C) be 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 –
...

(C) the trust's only deductions under section 642(c) are those attributable to charitable contributions taken into account by the trust under section 1366(a)(1) and section 702(a)(4).

Conclusion/Recommendation

We urge Congress to enact this tax simplification proposal to exempt from complying with the information reporting requirements of Internal Revenue Code section 6034(b)(1) trusts whose only charitable deductions are passed through to them from a flow-through entity (e.g. S corporation, LLC, or partnership). We look forward to working with you on this issue to achieve simplicity, effectiveness and efficiency as Congress considers this and other simplification legislation.

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Proposal: Allow a single 6-month automatic extension for entire Form 990 series and other information, excise and income tax returns of exempt organizations

Present Law

Currently, most of the forms in the Form 990 series (e.g., Form 990, Form 990-PF, etc.) are only permitted a 3-month automatic extension on Form 8868. Exempt organizations that need additional time must then submit another request on Form 8868 and demonstrate reasonable cause in order to receive approval by the IRS for up to another 3 month extension. However, Form 990-T is currently permitted an automatic 6-month extension.

Description of Proposal

We recommend that tax-exempt organizations also be allowed a single, automatic 6-month extension of time to file all information, excise and income tax returns on Forms 990 (complete series), 4720, 5227, 6069 and 8870.

AICPA previously submitted a comment letter recommending modification to Treas. Reg. § 1.6081-9(a) on [May 21, 2010](#) for all of the above referenced forms. In addition, it was also referenced in the AICPA's [October 8, 2010](#) comment letter to Congress on due dates in footnote 10.

Analysis

Complying with the tax law should be straightforward so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner. The principles of tax simplification would be advanced by one automatic extension as opposed to two extensions (one of which requires a detailed disclosure of the reason(s) why additional time is requested to file) to achieve the same result.

Good tax policy also suggests that similarly situated taxpayers should all receive fair and equitable treatment. Current law allows individuals and corporations an automatic 6-month extension of time to file their tax returns. See Treas. Reg. §§ 1.6081-3(a) and 1.6081-4(a). Tax exempt corporations, many of which are organized exclusively for religious, charitable, scientific, testing for public safety, literary or educational purposes, should not be subjected to a heightened administrative burden compared to for-profit corporations.

Allowance of an automatic 6-month extension would also promote efficiency and effectiveness of tax administration. A single automatic extension would save processing time at the IRS and eliminate the need for IRS approval of a second extension request. According to the Treasury Inspector General for Tax Administration Semiannual Report to Congress for the period ending September 30, 2009, "The IRS has experienced workforce challenges over the past few years, including recruiting, training and retaining

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employees, as well as an increasing number of employees who are eligible to retire.” It has been our experience as practitioners that second extensions are rarely denied on returns for exempt organizations and, therefore, the underlying concern for requiring a second extension request apparently is not warranted. The small benefit derived from the second extension process, if any, does not justify the burden to the IRS and taxpayers. As such, any reduced administrative burden on the IRS should be heavily considered, since it would promote a more efficient use of its already-limited resources.

Furthermore, implementation of one automatic extension would result in an immediate cost savings for both the Federal government and taxpayers. The elimination of the second extension request, and the acceptance or denial of the request, would decrease the preparation and processing costs for all parties involved. A taxpayer cannot file an additional extension request electronically. You must submit a paper version of the fully completed and signed form. The IRS also replies to a taxpayer’s request on paper and via the U.S. mail service.

One argument that might be made in opposition to the proposed revision to the regulations is that the public desires to view completed returns for exempt organizations as soon as possible after the organization’s year-end. However, many government and non-government organizations require a copy of an exempt organization’s Form 990 as a condition of making a grant. As such, there is an incentive not to delay filing in such instances.

In addition to working with board and audit committee schedules to review and/or approve financial statements and the Form 990, organizations with alternative investment portfolios are also at the mercy of the release of Form K-1s by investment partnerships. The final extended due date of the partnership returns is September 15. Therefore, tax-exempt investors are often waiting until September 15 to receive their Form K-1s, compute their unrelated business taxable income and assess other tax information reporting requirements. They have no choice but to file for a second extension in order to comply with the law. This is a significant issue for calendar year tax-exempt organizations.

Many of the large tax-exempt organizations need additional time to complete financial statement audits and correctly report amounts reported on investment Forms K-1. We are unaware of any evidence that requiring the filing of a second form would encourage taxpayers to file any sooner.

Conclusion/Recommendation

We propose that tax-exempt organizations be allowed an automatic 6-month extension of time to file all information, excise and income tax returns. The single extension approach would promote tax simplification, IRS efficiency, a decrease in preparation and processing costs and a reduction in the administrative burden on taxpayers.

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Proposal: Reinstatement retroactively and make permanent the fair market value exception under section 512(b)(13) and remove the binding contract requirement

Present Law

Prior to the passage of the Pension Protection Act of 2006 (PPA), section 512(b)(13) treated otherwise excluded rent, royalty, annuity and interest income received by an exempt organization as unrelated business income, if such income was received from a taxable or tax-exempt organization controlled by that parent organization (50% or more control, as computed both by direct ownership and by the constructive ownership rules of section 318). Such income was includible in the parent exempt organization's unrelated business income, and was subject to the unrelated business income tax to the extent payment of such by the controlled organization reduced its net unrelated income (or increased a net unrelated loss), determined as if the controlled entity were tax exempt.

The Pension Protection Act of 2006 modified section 512(b)(13) to provide that such payments would be treated as unrelated business income only to the extent that they exceeded the amount of any payment that would have been paid or accrued if such payment had been determined under the fair market value principles of section 482. Additionally, section 512(b)(13)(E)(i) imposed a tax addition for valuation misstatements. This provision applied only to payments made pursuant to a binding written contract in effect before December 31, 2005. Originally designed to sunset on December 31, 2007, this provision was re-extended several times, and finally sunset on December 31, 2011.

Description of Proposal

AICPA recommends that the expired provisions of section 512(b)(13) be reinstated retroactively and made permanent. We also recommend that the binding contract requirement be removed.

Analysis

Inter-organizational transactions are a normal and necessary part of modern business operations, both for nonprofit and for-profit entities alike. When conducted at arm's-length for fair value, such transactions are in line with the "prudent investment" standard which generated the original exceptions to taxation of rents, royalties, annuities and interest under section 512(b)(1). We believe the provision should be retroactively reinstated to prevent the report complexities that come with having a one-year disparate tax treatment of an ongoing contract.

Conclusion/Recommendation

As long as fair market value rules are followed, there is no genuine and substantial reason to differentiate, for purposes of these types of transactions, between related and unrelated

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entities. Therefore, we urge Congress to reinstate retroactively and make permanent the fair market value exception under section 512(b)(13). We also recommend the deletion of the binding contract requirement.

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Proposal: Expand the exception from section 509(f)(2), which prohibits an organization from qualifying for section 509(a)(3) status if it accepted certain gifts, to be consistent with the technical change made to section 4958(c)(3)(C)

Present Law

The PPA made numerous changes to the rules governing section 509(a)(3) “supporting organizations,” providing for tighter, more restrictive operations by these types of charitable entities – focusing particularly on potentially abusive transactions between supporting organizations and their controllers and/or substantial contributors. Exceptions were carved out for certain transactions between supporting organizations and the organizations they support; however, the wording of these exceptions created uncertainty as to their applicability to certain types of non-charitable organizations that are afforded “supported organization” status under section 509(a)(2).

The restrictions (and exceptions) created by the PPA were these:

- A change to section 4958(c)(3) by the PPA provided in two separate subsections (sections 4958(c)(3)(A)(i)(II) and 4958(c)(3)(C)(ii)) for an exception to the general rule imposing automatic excess benefit treatment of loans paid by supporting organizations to disqualified persons and of grants, loans, compensation or other similar payment paid by supporting organizations to substantial contributors. The exception provided in each of those subsections was for “an organization described in paragraph (1), (2), or (4) of section 509(a).”
- New section 509(f)(2), as added by the PPA, prohibited an organization from qualifying for section 509(a)(3) “Type I” or “Type III” status if it accepted a gift from a person who directly or indirectly controlled the organization being supported – but provided “exception” language with regard to the “controlling person” restriction for “an organization” described in paragraph (1), (2), or (4) of section 509(a).

Description of Proposal

The AICPA recommends that Congress amend section 509(f)(2)(B)(i) to read (change in italics):

509(f)(2)(B)(i)

a person (other than an organization described in paragraph (1), (2), or (4) of section 509(a), or any organization which is treated as described in such paragraph (2) by reason of the last sentence of section 509(a) and which is a supported organization (as defined in section 509(f)(3)) of the organization to which subparagraph (A) applies) who directly or indirectly controls, either alone or together with persons described in clauses (ii) and (iii), the governing body of such supported organization . . .

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Analysis

Unfortunately, the PPA changes outlined above arguably could be interpreted as not being applicable to section 501(c)(4), (5), and (6) organizations that may qualify as “supported” organizations by virtue of the flush language of section 509(a). This language provides that non-charitable organizations may be supported by section 509(a)(3) organizations if their financial profile matches that of a charitable section 509(a)(2) entity. Accordingly, post-PPA, there was concern that greater restrictions under section 4958(c)(3) and 509(f)(2) could be imposed on non-charitable supported organizations, than on charitable supported entities.

The Tax Technical Corrections Act of 2007 (TCCA), as signed by President Bush on December 29, 2007, rectified one of these concerns, by making a technical change to section 4958(c)(3)(C). TCCA struck this language:

Section 4958(c)(3)(C)(ii) EXCEPTION.—Such term shall not include any organization described in paragraph (1), (2), or (4) of section 509(a).

And substituted the following language:

Section 4958(c)(3)(C)(ii) EXCEPTION—Such term shall not include—

- (I) any organization described in paragraph (1), (2), or (4) of section 509(a), and
- (II) any organization which is treated as described in such paragraph (2) by reason of the last sentence of section 509(a) and which is a supported organization (as defined in section 509(f)(3)) of the organization to which subparagraph (A) applies.

The amendment made by TCCA 2007 expanded the exception to the term “substantial contributor” to encompass transactions between a supported section 501(c)(4), (5) or (6) organization and its section 509(a)(3) supporting organization. This had the effect of exempting supported non-charitable organizations from the excess benefit transaction rule of section 4958(c).

Conclusion/Recommendation

A technical correction is needed for section 509(f)(2). We suggest that such a correction would further reduce confusion with regard to transactions between supporting organizations and their non-charitable supported organizations.