Mr. Chairman and Members of the Committee, as Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the “Joint Committee staff”) at this hearing concerning simplification of the Federal tax system.

A. Overview

Under the Internal Revenue Code, the Joint Committee is required to report, at least once each Congress, to the Senate Committee on Finance and the House Committee on Ways and Means on the overall state of the Federal tax system.¹ This study is required to include recommendations with respect to possible simplification proposals and such other matters relating to the administration of the Federal tax system as the Joint Committee may deem

¹ Internal Revenue Code (“Code”) sec. 8022(3)(B). This provision was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. No. 105-206). The requirement for a study stemmed from recommendations of the National Commission on Restructuring the Internal Revenue Service in 1997. Report of the Commission on Restructuring the Internal Revenue Service: A Vision for a New IRS: Report of the National Commission on Restructuring the Internal Revenue Service, June 27, 1997. Preparation of the Joint Committee study is subject to specific appropriations by the Congress. For fiscal year 2000, the staff of the Joint Committee on Taxation (“Joint Committee staff”) advised the House and Senate Committees on Appropriations that an appropriation of $200,000 would be required for the Joint Committee staff to undertake the study and amounts were appropriated for this purpose.
advisable. The Joint Committee staff has just completed work on this study and I am pleased to have this opportunity to present the Joint Committee staff findings to you.

In the course of this study, the Joint Committee staff:

(1) Undertook an extensive review of prior simplification proposals, including review of legal and economic literature making simplification and other legislative recommendations during the past 10 years; prior published and unpublished work of the Joint Committee staff with respect to simplification; various published Treasury studies; materials published by the National Taxpayer Advocate and the Commissioner of Internal Revenue, including the Tax Complexity Study issued by the Commissioner on June 5, 2000; and published simplification recommendations of various professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute;

(2) Assembled two groups of advisors (approximately 40 academic advisors and approximately 25 individuals who previously held senior-level tax policy positions in the Federal government) to assist in the analysis of various simplification proposals and to solicit simplification ideas that may not have been previously advanced;

(3) Conducted a full-day meeting with representatives of the Internal Revenue Service (“IRS”) to solicit comments and suggestions on specific issues under the Federal tax system and a separate meeting with the IRS and the Director of the American University Washington College of Law Tax Clinic on issues relating to the present-law earned income credit;

(4) Requested that the General Accounting Office provide information that would assist in measuring the effects of complexity on taxpayers, including the size of the Code, the number of forms, instructions, and publications, and taxpayer errors and requests for assistance to the IRS; and

(5) Requested the Congressional Research Service to provide information regarding legislative and regulatory activity relating to the Federal tax system and information on the efforts of foreign countries to simplify their tax laws.

The Joint Committee staff (1) collected background information on the Federal tax system, (2) identified the sources and effects of complexity in the present-law tax system, (3) identified provisions adding complexity to the present-law tax system, and (4) developed simplification recommendations.
B. Background Information on the Federal Tax System

The Joint Committee staff collected background information on the sources of complexity in the Federal tax law and data concerning the filing of tax forms, taxpayer assistance, and information on error rates and tax controversies. Some of the information collected by the Joint Committee staff (with the assistance of the General Accounting Office) included the following:

(1) Over 100 million individual income tax returns are filed annually on behalf of roughly 90 percent of the U.S. population;

(2) The Internal Revenue Code consists of approximately 1,395,000 words;

(3) There are 693 sections of the Internal Revenue Code that are applicable to individual taxpayers, 1,501 sections applicable to businesses, and 445 sections applicable to tax-exempt organizations, employee plans, and governments;

(4) As of June 2000, the Treasury Department had issued almost 20,000 pages of regulations containing over 8 million words;

(5) During 2000, the IRS published guidance for taxpayers in the form of 58 revenue rulings, 49 revenue procedures, 64 notices, 100 announcements, at least 2,400 private letter rulings and technical advice memoranda, 10 actions on decision, and 240 field service advice;

(6) For 1999, publications of the IRS included 649 forms, schedules, and separate instructions totaling more than 16,000 lines, 159 worksheets contained in IRS instructions to forms, and approximately 340 publications totaling more than 13,000 pages;

(7) A taxpayer filing an individual income tax return could be faced with a return (Form 1040) with 79 lines, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of filing numerous other forms (IRS Publication 17, Your Federal Income Tax (273 pages), lists 18 commonly used forms other than Form 1040 and its schedules);

(8) In 1997, of the more than 122 million individual income tax returns filed, nearly 69 million were filed on Form 1040, as opposed to Form 1040A, Form 1040EZ, or Form 1040PC;

(9) In 1999, taxpayers contacted the IRS for assistance approximately 117 million times, up from 105 million contacts in 1996; and

(10) The use of paid return preparers increased from 48 percent of returns filed in 1990 to 55 percent of returns filed in 1999 (a 27 percent increase) and the use of computer software for return preparation increased from 16 percent of returns filed in 1990 to 46 percent of returns filed in 1999 (a 188 percent increase).
C. Sources of Complexity in the Present-Law Federal Tax System

In the course of its study, the Joint Committee staff identified various sources of complexity in the present-law Federal tax system. No single source of complexity can be identified that is primarily responsible for the state of the present-law system. Rather, the Joint Committee staff found that, for any complex provision, a number of different sources of complexity might be identified.

Among these sources of complexity the Joint Committee staff identified are: (1) a lack of clarity and readability of the law; (2) the use of the Federal tax system to advance social and economic policies; (3) increased complexity in the economy; and (4) the interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. The lack of clarity and readability of the law results from (1) statutory language that is, in some cases, overly technical and, in other cases, overly vague; (2) too much or too little guidance with respect to certain issues; (3) the use of temporary provisions; (4) frequent changes in the law; (5) broad grants of regulatory authority; (6) judicial interpretation of statutory and regulatory language; and (7) the effects of the Congressional budget process.
D. Effects of Complexity on the Federal Tax System

There are a number of ways in which complexity can affect the Federal tax system. Among the more commonly recognized effects are (1) decreased levels of voluntary compliance; (2) increased costs for taxpayers; (3) reduced perceptions of fairness in the Federal tax system; and (4) increased difficulties in the administration of tax laws. Although there is general agreement among experts that complexity has these adverse effects, there is no consensus on the most appropriate method of measuring the effects of complexity. The Joint Committee staff explored certain information that may be helpful in assessing the possible effects of complexity in the present-law Federal tax system.

It is widely reported that complexity leads to reduced levels of voluntary compliance. Complexity can create taxpayer confusion, which may affect the levels of voluntary compliance through inadvertent errors or intentional behavior by taxpayers. The Joint Committee staff found that it is not possible to measure the effects of complexity on voluntary compliance because (1) there has been no consistent measurement of the levels of voluntary compliance in more than a decade and (2) there is no generally agreed measure of changes in the level of complexity in the tax system over time.

Commentators also state that complexity of the Federal tax systems results in increased costs of compliance to taxpayers. The Joint Committee staff explored some of the commonly used measures of the costs of compliance, such as the estimate of time required to prepare tax returns, but found that there is no reliable measure of the change in costs of compliance. The Joint Committee staff did find, however, that individual taxpayers have significantly increased their use of tax return preparers, computer software for tax return preparation, and IRS taxpayer assistance over the last 10 years.

Complexity reduces taxpayers’ perceptions of fairness of the Federal tax system by (1) creating disparate treatment of similarly situated taxpayers, (2) creating opportunities for manipulation of the tax laws by taxpayers who are willing and able to obtain professional advice, and (3) disillusioning taxpayers to Federal tax policy because of the uncertainty created by complex laws.

Finally, complexity makes it more difficult for the IRS to administer present law. Complex tax laws make it more difficult for the IRS to explain the law to taxpayers in a concise and understandable manner in forms, instructions, publications, and other guidance. In addition, the IRS is more likely to make mistakes in the assistance provided to taxpayers and in the application of the law.
E. Identifying Provisions Adding Complexity

In conducting this study, the Joint Committee staff looked at a variety of factors that contribute to complexity. Although the Joint Committee staff’s focus was on complexity as it affects taxpayers (either directly or through the application of the law by tax practitioners), the Joint Committee staff also took into account complexity encountered by the IRS in administering the tax laws.

The Joint Committee staff generally did not take into account the level of sophistication of taxpayers or the complexity of transactions in identifying complex provisions; however, as discussed below, such factors were taken into account in making recommendations for simplification.

Factors the Joint Committee staff analyzed in identifying provisions that add complexity include the following:

(1) The existence of multiple provisions with similar objectives;
(2) The nature and extent of mathematical calculations required by a provision;
(3) Error rates associated with a provision;
(4) Questions frequently asked the IRS by taxpayers;
(5) The length of IRS worksheets, forms, instructions, and publications needed to explain and apply a provision;
(6) Recordkeeping requirements;
(7) The extent to which a provision results in disputes between the IRS and taxpayers;
(8) The extent to which a provision makes it difficult for taxpayers to plan and structure normal business transactions;
(9) The extent to which a provision makes it difficult for taxpayers to estimate and understand their tax liabilities;
(10) Whether a provision accomplishes its purposes and whether particular aspects of a provision are necessary to accomplish the purposes of the provision;
(11) Lack of consistency in definitions of similar terms;
(12) The extent to which a provision creates uncertainty;
(13) Whether a provision no longer serves any purpose or is outdated;
(14) Whether the statutory rules are easily readable and understandable;
(15) The extent to which major rules are provided in regulations and other guidance rather than in the Code; and

(16) The existence of appropriate administrative guidance.
F. Summary of Joint Committee Staff Recommendations

1. Overview

The Joint Committee staff analyzed each possible simplification recommendation from a variety of perspectives, including:

(1) The extent to which simplification could be achieved by the recommendation;

(2) Whether the recommendation improves the fairness or efficiency of the Federal tax system;

(3) Whether the recommendation improves the understandability and predictability (i.e., transparency) of the Federal tax system;

(4) The complexity of the transactions that would be covered by the recommendation and the sophistication of affected taxpayers;

(5) Administrative feasibility and enforceability of the recommendation;

(6) The burdens imposed on taxpayers, tax practitioners, and tax administrators by changes in the tax law; and

(7) Whether a provision of present law could be eliminated because it is obsolete or duplicative.

In developing possible simplification recommendations, the Joint Committee staff applied one overriding criterion: the Joint Committee staff would make a simplification recommendation only if the recommendation did not fundamentally alter the underlying policy articulated by the Congress in enacting the provision. As a result of applying this criterion, the Joint Committee staff did not make certain simplification recommendations reviewed in the course of this study. However, further simplification could be achieved by addressing certain of the policy decisions made in developing various provisions of present law.

Among the types of issues with respect to which the Joint Committee staff did not make specific simplification recommendations because of policy considerations are the following: (1) reducing the number of individual income tax filing statuses; (2) determining marital status; (3) reducing the number of exclusions from income; (4) making structural modifications to above-the-line deductions and itemized deductions; (5) increasing the standard deduction; (6) making structural changes to the dependency exemption, the child credit, and the earned income credit; (7) modifying the treatment of home mortgage interest of individuals; (8) modifying the distinction between ordinary income (and losses) and capital gains (and losses); (9) integrating the corporate and individual income tax; (10) altering the basic rules relating to corporate mergers and acquisitions; (11) eliminating the personal holding company and accumulated earnings tax provisions; (12) reducing the number of separate tax rules for different types of pass-through entities; (13) determining whether an expenditure is a capital expenditure that cannot be currently expensed; (14) modifying the rules relating to depreciation of capital assets; (15) providing uniform treatment of economically similar financial instruments; (16) modifying
the rules relating to taxation of foreign investments; (17) modifications to the foreign tax credit; (18) altering the taxation of individual taxpayers with respect to cross border portfolio investments overseas; (19) changing the determination of an individual’s status as an employee or independent contractor; (20) clarifying the treatment of limited partners for self-employment tax purposes; (21) providing alternative methods of return filing; and (22) eliminating overlapping jurisdiction of litigation relating to the Federal tax system.

The Joint Committee staff did not conclude that a simplification recommendation was inconsistent with the underlying policy of a provision merely because the recommendation might alter the taxpayers affected.

In some instances, the Joint Committee staff concluded that a provision did not accomplish the underlying policy articulated when the provision was enacted. In such instances, the Joint Committee staff concluded that recommending elimination or substantial modification of a provision was not inconsistent with the underlying policy.

2. Alternative minimum tax

The Joint Committee staff recommends that the individual and corporate alternative minimum taxes should be eliminated. The individual and corporate alternative minimum taxes contribute complexity to the present-law tax system by requiring taxpayers to calculate Federal income tax liability under two different systems.

The Joint Committee staff believes that the individual alternative minimum tax no longer serves the purposes for which it was intended. The present-law structure of the individual alternative minimum tax expands the scope of the provisions to taxpayers who were not intended to be alternative minimum tax taxpayers. The number of individual taxpayers required to comply with the complexity of the individual alternative minimum tax calculations will continue to grow due to the lack of indexing of the minimum tax exemption amounts and the effect of the individual alternative minimum tax on taxpayers claiming nonrefundable personal credits. By 2011, the Joint Committee staff projects that more than 11 percent of all individual taxpayers will be subject to the individual alternative minimum tax.

Furthermore, legislative changes since the Tax Reform Act of 1986 have had the effect of partially conforming the tax base for alternative minimum tax purposes to the tax base for regular tax purposes. Thus, the Joint Committee staff finds it appropriate to recommend that the alternative minimum tax be eliminated.

3. Individual income tax

Uniform definition of a qualifying child

The Joint Committee staff recommends that a uniform definition of qualifying child should be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care tax credit, and head of household filing status. Under this uniform definition, in general, a child would be a qualifying child of a taxpayer if the child has the same principal place of abode as the taxpayer for more than one half the taxable year. Generally, a “child” would be defined as an individual who is (1) the son,
daughter, stepson, stepdaughter, brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any of such individuals, and (2) under age 19 (or under age 24 in the case of a student). As under present law, the child would have to be under age 13 for purposes of the dependent care credit. No age limit would apply in the case of disabled children. Adopted children, children placed with the taxpayer for adoption by an authorized agency, and foster children placed by an authorized agency would be treated as the taxpayer’s child. A tie-breaking rule would apply if more than one taxpayer claims a child as a qualifying child. Under the tie-breaking rule, the child generally would be treated as a qualifying child of the child’s parent.

Adopting a uniform definition of qualifying child would make it easier for taxpayers to determine whether they qualify for the various tax benefits for children and reduce inadvertent taxpayer errors arising from confusion due to different definitions of qualifying child. A residency test is recommended as the basis for the uniform definition because it is easier to apply than a support test.

This recommendation would provide simplification for substantial numbers of taxpayers. Under present law, it is estimated that, for 2001, 44 million returns will claim a dependency exemption for a child, 19 million returns will claim the earned income credit, 6 million returns will claim the dependent care credit, 26 million returns will claim the child credit, and 18 million returns will claim head of household filing status.

**Dependent care benefits**

The Joint Committee staff recommends that the dependent care credit and the exclusion for employer-provided dependent care assistance should be conformed by: (1) providing that the amount of expenses taken into account for purposes of the dependent care credit is the same flat dollar amount that applies for purposes of the exclusion (i.e., $5,000 regardless of the number of qualifying individuals); (2) eliminating the reduction in the credit for taxpayers with adjusted gross income above certain levels; and (3) providing that married taxpayers filing separate returns are eligible for one half the otherwise applicable maximum credit.

The recommendation would eliminate the confusion caused by different rules for the two present-law tax benefits allowable for dependent care expenses. The recommendation also would simplify the dependent care credit by eliminating features of the credit that require additional calculations by taxpayers.

This recommendation could provide simplification for as many as 6 million returns, the number of returns estimated to claim the dependent care credit in 2001.

**Earned income credit**

The Joint Committee staff recommends that the earned income credit should be modified as follows: (1) the uniform definition of qualifying child (including the tie-breaking rule) recommended by the Joint Committee staff should be adopted for purposes of the earned income credit; and (2) earned income should be defined to include wages, salaries, tips, and other employee compensation to the extent includible in gross income for the taxable year, and net earnings from self employment.
Applying the uniform definition of child recommended by the Joint Committee staff to the earned income credit would make it easier for taxpayers to determine whether they qualify for the earned income credit and would reduce inadvertent errors caused by different definitions. The elimination of nontaxable compensation from the definition of earned income would alleviate confusion as to what constitutes earned income and enable taxpayers to determine earned income from information already included on the tax return.

This recommendation could provide simplification for as many as 19 million returns, the number of returns estimated to claim the credit in 2001.

**Head of household filing status**

The Joint Committee staff recommends that head of household filing status should be available with respect to a child only if the child qualifies as a dependent of the taxpayer under the Joint Committee staff’s recommended uniform definition of qualifying child. Applying the uniform definition of child recommended by the Joint Committee staff would make it easier for taxpayers to determine if they are eligible for head of household status due to a child and reduce taxpayer errors due to differing definitions of qualifying child.

This recommendation could provide simplification for up to 18 million returns that are estimated to be filed in 2001 using head of household filing status.

**Surviving spouse status**

The Joint Committee staff recommends that surviving spouse status should be available only for one year and that the requirement that the surviving spouse have a dependent should be eliminated. The recommendation would eliminate confusion about who qualifies for surviving spouse status.

**Phase-outs and phase-ins**

The Joint Committee staff recommends that the following phase-outs should be eliminated: (1) overall limitation on itemized deductions (known as the “PEASE” limitation); (2) phase-out of personal exemptions (known as “PEP”); (3) phase-out of child credit; (4) partial phase-out of the dependent care credit; (5) phase-outs relating to individual retirement arrangements; (6) phase-out of the HOPE and Lifetime Learning credits; (7) phase-out of the deduction for student loan interest; (8) phase-out of the exclusion for interest on education savings bonds; and (9) phase-out of the adoption credit and exclusion.

These phase-outs require taxpayers to make complicated calculations and make it difficult for taxpayers to plan whether they will be able to utilize the tax benefits subject to the phase-outs. Eliminating the phase-outs would eliminate complicated calculations and make planning easier. These phase-outs primarily address progressivity, which can be more simply addressed through the rate structure.

This recommendation would provide simplification for up to 30 million returns that are subject to one or more of the present law phase-outs and phase-ins.
**Taxation of Social Security benefits**

The Joint Committee staff recommends that the amount of Social Security benefits includible in gross income should be a fixed percentage of benefits for all taxpayers. The Joint Committee staff further recommends that the percentage of includible benefits should be defined such that the amount of benefits excludable from income approximates individuals’ portion of Social Security taxes. The recommendation would eliminate the complex calculations and 18-line worksheet currently required in order to determine the correct amount of Social Security benefits includible in gross income. This recommendation could provide simplification for as many as 12 million returns that show taxable Social Security benefits; 5.7 million of such returns are in the income phase-out range.

**Individual capital gains and losses**

The Joint Committee staff recommends that the current rate system for capital gains should be replaced with a deduction equal to a fixed percentage of the net capital gain. The deduction should be available to all individuals. The recommendation would simplify the computation of the taxpayer’s tax on capital gains and streamline the capital gains tax forms and schedules for individuals for as many as 27 million returns estimated to have capital gains or losses in 2001.

The Joint Committee staff recommends that, for purposes of ordinary loss treatment under sections 1242 and 1244, the definition of small business should be conformed to the definition of small business under section 1202, regardless of the date of issuance of the stock. The recommendation would reduce complexity by conforming the definition of small business that applies for purposes of preferential treatment of capital gain or loss.

**Two-percent floor on miscellaneous itemized deductions**

The Joint Committee staff recommends that the two-percent floor applicable to miscellaneous itemized deductions should be eliminated. The Joint Committee staff finds that the two-percent floor applicable to miscellaneous itemized deductions has added to complexity because it has: (1) placed pressure on individuals to claim that they are independent contractors, rather than employees; (2) resulted in extensive litigation with respect to the proper treatment of certain items, such as attorneys’ fees; (3) resulted in inconsistent treatment with respect to similar items of expense; and (4) created pressure to enact deductions that are not subject to the floor. Although the two-percent floor was enacted, in part, to reduce complexity, it has instead shifted complexity to these other issues relating to miscellaneous itemized deductions.

**Provisions relating to education**

**Definition of qualifying higher education expenses**

The Joint Committee staff recommends that a uniform definition of qualifying higher education expenses should be adopted. A uniform definition would eliminate the need for taxpayers to understand multiple definitions if they use more than one education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions.
Combination of HOPE and Lifetime Learning credits

The Joint Committee staff recommends that the HOPE and Lifetime Learning credits should be combined into a single credit. The single credit would: (1) utilize the present-law credit rate of the Lifetime Learning credit; (2) apply on a per-student basis; and (3) apply to eligible students as defined under the Lifetime Learning credit.

Combining the two credits would reduce complexity and confusion by eliminating the need to determine which credit provides the greatest benefit with respect to one individual and to determine if a taxpayer can qualify for both credits with respect to different individuals.

Interaction among education tax incentives

The Joint Committee staff recommends that restrictions on the use of education tax incentives based on the use of other education tax incentives should be eliminated and replaced with a limitation that the same expenses could not qualify under more than one provision. The recommendation would eliminate the complicated planning required in order to obtain full benefit of the education tax incentives and reduce traps for the unwary. The recommendation would eliminate errors by taxpayers due to the provisions that trigger adverse consequences as a result of actions by persons other than the taxpayer.

Student loan interest deduction

The Joint Committee staff recommends that the 60-month limit on deductibility of student loan interest should be eliminated. The recommendation would make determining the amount of deductible interest easier because taxpayers would not need to determine the history of the loan’s payment status.

Exclusion for employer-provided educational assistance

The Joint Committee staff recommends that the exclusion for employer-provided educational assistance should be made permanent. The recommendation would reduce administrative burdens on employers and employees caused by the present practice of allowing the exclusion to expire and then extending it. The recommendation would make it easier for employees to plan regarding education financing. The recommendation would eliminate the need to apply a facts and circumstances test to determine if education is deductible in the absence of the exclusion.

Taxation of minor children

The Joint Committee staff recommends that the tax rate schedule applicable to trusts should be applied with respect to the net unearned income of a child taxable at the parents’ rate under present law. In addition, the Joint Committee staff recommends that the parental election to include a child’s income on the parents’ return should be available irrespective of (1) the amount and type of the child’s income, and (2) whether withholding occurred or estimated tax payments were made with respect to the child’s income. Utilizing the trust rate schedule would eliminate the complexity arising from the linkage of the returns of parent, child, and siblings. Expanding the parental election would decrease the number of separate returns filed by children.
4. Individual retirement arrangements, qualified retirement plans, and employee benefits

**Individual retirement arrangements (‘IRAs’)**

The Joint Committee staff recommends that the income limits on eligibility to make deductible IRA contributions, Roth IRA contributions, and conversions of traditional IRAs to Roth IRAs should be eliminated. Further, the Joint Committee staff recommends that the ability to make nondeductible contributions to traditional IRAs should be eliminated. The Joint Committee staff recommends that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs.

The IRA recommendations would reduce the number of IRA options and conform eligibility criteria for remaining IRAs, thus simplifying taxpayers’ savings decisions.

**Recommendations relating to qualified retirement plans**

**Definition of compensation**

The Joint Committee staff recommends that: (1) a single definition of compensation should be used for all qualified retirement plan purposes, including determining plan benefits, and (2) compensation should be defined as the total amount that the employer is required to show on a written statement to the employee, plus elective deferrals and contributions for the calendar year. The recommendation would eliminate the need to determine different amounts of compensation for various purposes or periods.

**Nondiscrimination rules for qualified plans**

The Joint Committee staff recommends that: (1) the ratio percentage test under the minimum coverage rules should be modified to allow more plans to use the test, (2) excludable employees should be disregarded in applying the minimum coverage and general nondiscrimination rules, and (3) the extent to which cross-testing may be used should be specified in the Code. The first recommendation would simplify minimum coverage testing by eliminating the need for some plans to perform the complex calculations required under the average benefit percentage test. The second recommendation would simplify nondiscrimination testing by eliminating the need to analyze the effect of covering excludable employees under the plan. The third recommendation would provide certainty and stability in the design of qualified retirement plans that rely on cross-testing by eliminating questions as to whether and to what extent the cross-testing option is available.

**Vesting requirements**

The Joint Committee staff recommends that the vesting requirements for all qualified retirement plans should be made uniform by applying the top-heavy vesting schedules to all plans. A single set of vesting rules would provide consistency among plans and will reduce complexity in plan documents and in the determination of vested benefits.
SIMPLE plans

The Joint Committee staff recommends that the rules relating to SIMPLE IRAs and SIMPLE 401(k) plans should be conformed by (1) allowing State and local government employers to adopt SIMPLE 401(k) plans, (2) applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans, and (3) applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans. This recommendation would make choosing among qualified retirement plan designs easier for all small employers.

Definitions of highly compensated employee and owner

The Joint Committee staff recommends that uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes. Uniform definitions would eliminate multiple definitions of highly compensated employee and owner for various purposes, thereby allowing employers to make a single determination of highly compensated employees and owners.

Contribution limits for tax-sheltered annuities

The Joint Committee staff recommends that the contribution limits applicable to tax-sheltered annuities should be conformed to the contribution limits applicable to comparable qualified retirement plans. Conforming the limits would reduce the recordkeeping and computational burdens related to tax-sheltered annuities and eliminate confusing differences between tax-sheltered annuities and qualified retirement plans.

Minimum distribution rules

The Joint Committee staff recommends that the minimum distribution rules should be simplified by providing that: (1) no distributions are required during the life of a participant; (2) if distributions commence during the participant’s lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant’s death; and (3) if distributions either do not commence during the participant’s lifetime or commence during the participant’s lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant’s beneficiary or beneficiaries within five years of the participant’s death. The elimination of minimum required distributions during the life of the participant and the establishment of a uniform rule for post-death distributions would significantly simplify compliance by plan participants and their beneficiaries, as well as plan sponsors and administrators.

Exceptions to the early withdrawal tax; half-year conventions

The Joint Committee staff recommends that the exceptions to the early withdrawal tax should be uniform for all tax-favored retirement plans and that the applicable age requirements for the early withdrawal tax and permissible distributions from section 401(k) plans should be changed from age 59-1/2 to age 55. Uniform rules for distributions would make it easier for individuals to determine whether distributions are permitted and whether distributions will be subject to the early withdrawal tax.
Allow all governmental employers to maintain section 401(k) plans

The Joint Committee staff recommends that all State and local governments should be permitted to maintain section 401(k) plans. This will eliminate distinctions between the types of plans that may be offered by different types of employers and simplify planning decisions.

Redraft provisions dealing with section 457 plans

The Joint Committee staff recommends that the statutory provisions dealing with eligible deferred compensation plans should be redrafted so that separate provisions apply to plans maintained by State and local governments and to plans maintained by tax-exempt organizations. This will make it easier for employers to understand and comply with the requirements applicable to their plans.

Attribution rules

The Joint Committee staff recommends that the attribution rules used in determining controlled group status under section 1563 should be used in determining ownership for all qualified retirement plan purposes. Uniform attribution rules would enable the employer to perform a single ownership analysis for all relevant qualified retirement plan purposes.

Basis recovery rules for qualified retirement plans and IRAs

The Joint Committee staff recommends that a uniform basis recovery rule should apply to distributions from qualified retirement plans, traditional IRAs, and Roth IRAs. Under this uniform rule, distributions would be treated as attributable to basis first, until the entire amount of basis has been recovered. The uniform basis recovery rule would eliminate the need for individuals to calculate the portion of distributions attributable to basis and would apply the same basis recovery rule to all types of tax-favored retirement plans.

Modifications to employee benefit plan provisions

Cafeteria plan elections

The Joint Committee staff recommends that the frequency with which employees may make, revoke, or change elections under cafeteria plans should be determined under rules similar to those applicable to elections under cash or deferred arrangements. Applying simpler election rules to cafeteria plans would reduce confusion and administrative burdens for employers and employees.

Excludable employees

The Joint Committee staff recommends that a uniform definition of employees who may be excluded for purposes of the application of the nondiscrimination requirements relating to group-term life insurance, self-insured medical reimbursement plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits, and voluntary employees’ beneficiary associations should be adopted. A uniform definition of excludable
employees would eliminate minor distinctions that exist under present law and make nondiscrimination testing easier.

5. Corporate income tax

Collapsible corporations

The Joint Committee staff recommends that the collapsible corporation provisions should be eliminated. This recommendation would eliminate a complex provision that became unnecessary with the enactment of the corporate liquidation rules of the Tax Reform Act of 1986.

Active business requirement of section 355

The Joint Committee staff recommends that the active business requirement of section 355 should be applied on an affiliated group basis. Thus, the “substantially all” test should be eliminated. This recommendation would simplify business planning for corporate groups that use a holding company structure.

Uniform definition of a family

The Joint Committee staff recommends that a uniform definition of a family should be used in applying the attribution rules used to determine stock ownership. For this purpose, a “family” should be defined as including brothers and sisters (other than step-brothers and step-sisters), a spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance), ancestors and lineal descendants. An exception would be provided with respect to limiting multiple tax benefits in the case of controlled corporations (section 1561), in which case the present-law rules of section 1563(e) would be retained. A single definition of a family would eliminate many of the inconsistencies in the law that have developed over time and would reflect currently used agreements relating to divorce and separation.

Redemption through use of related corporations (section 304)

The Joint Committee staff recommends that section 304 should apply only if its application results in a dividend (other than a dividend giving rise to a dividends received deduction). The recommendation would limit the application of a complex set of rules.

Corporate reorganizations

The Joint Committee staff recommends that assets acquired in a tax-free reorganization pursuant to section 368(a)(1)(D) or 368(a)(1)(F) should be allowed to be transferred to a controlled subsidiary without affecting the tax-free status of the reorganization. This recommendation would harmonize the rules regarding post-reorganization transfers to controlled subsidiaries and eliminate the present-law uncertainties with respect to such transfers.

The Joint Committee staff recommends that the rules relating to the treatment of property received by a shareholder in reorganizations involving corporations under common control or a
The Joint Committee staff recommends that a stock redemption incident to a divorce should be treated as a taxable redemption of the stock of the transferor spouse, unless both parties agree in writing that the stock is to be treated as transferred to the other spouse prior to the redemption. If one spouse actually receives a distribution and purchases the other spouse’s stock, the form of the transaction would be respected. The recommendation would eliminate uncertainty and litigation regarding the treatment of the parties when a corporate stock redemption occurs incident to a divorce.

6. Pass-through entities

Partnerships

The Joint Committee staff recommends that references in the Code to “general partners” and “limited partners” should be modernized consistent with the purpose of the reference. In most cases, the reference to limited partners could be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners could be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his or her own personal services. The recommendation would provide simplification by modernizing these references to accommodate limited liability companies, whose owners generally are partners within the meaning of Federal tax law, but are not either general partners or limited partners under State law.

The Joint Committee staff recommends that the special reporting and audit rules for selecting large partnerships should be eliminated and that large partnerships should be subject to the general rules applicable to partnerships. The recommendation would simplify the reporting and audit rules by eliminating the least-used sets of rules.

The Joint Committee staff recommends that the timing rules for guaranteed payments to partners and for transactions between partnerships and partners not acting in their capacity as such should be conformed. The timing rule for all such payments and transactions should be based on the time the partnership takes the payment into account. The recommendation would provide simplification by eliminating one of two conflicting timing rules applicable to similar types of situations.
S corporations

The Joint Committee staff recommends that the special termination rule for certain S corporations with excess passive investment income should be eliminated. In addition, the corporate-level tax on excess passive investment income should be modified so that the tax would be imposed only on an S corporation with accumulated earnings and profits in any year in which more than 60 percent (as opposed to 25 percent) of its gross income is considered passive investment income. The recommendation would eliminate much of the uncertainty and complexity of present law for S corporations that are required to characterize their income as active or passive income, and at the same time would conform the tax with the personal holding company rules applicable to C corporations (that address a similar concern).

The Joint Committee staff recommends that the special rules for the taxation of electing small business trusts should be eliminated and that the regular rates of Subchapter J should apply to these trusts and their beneficiaries. Under this recommendation, no election to be a qualified subchapter S trust could be made in the future. The recommendation would eliminate some of the complexity regarding the operating rules for electing small business trusts as well as the overlapping rules for electing small business trusts and qualified Subchapter S trusts.

7. General business issues

Like-kind exchanges

The Joint Committee staff recommends that a taxpayer should be permitted to elect to rollover gain from the disposition of appreciated business or investment property described in section 1031 if like-kind property is acquired by the taxpayer within 180 days before or after the date of the disposition (but not later than the due date of the taxpayer’s income tax return). The determination of whether properties are considered to be of a “like-kind” would be the same as under present law.

The Joint Committee staff recommends that, for purposes of determining whether property satisfies the holding period requirement for a like-kind exchange, a taxpayer’s holding period and use of property should include the holding period and use of property by the transferor in the case of property (1) contributed to a corporation or partnership in a transaction described in section 351 or 721, (2) acquired by a corporation in connection with a transaction qualifying as a reorganization under section 368, (3) distributed by a partnership to a partner, and (4) distributed by a corporation in a transaction to which section 332 applies. In addition, the Joint Committee staff recommends that property whose use changes should not qualify for like-kind exchange treatment unless it is held for productive use in a trade or business or investment for a specified period of time.

The recommendation would reduce complexity by allowing taxpayers to reinvest the proceeds from the sale of business or investment property into other like-kind property directly without engaging in complicated “exchanges” designed to meet the statutory and regulatory rules regarding deferred exchanges. In addition, the recommendation would remove the confusion and uncertainty under section 1031 with respect to whether a taxpayer is considered to hold property
for productive use in a trade or business or for investment when the property has been recently transferred.

**Low-income housing tax credit**

The Joint Committee staff recommends that the payout period for the low-income housing tax credit should be conformed to the initial compliance period (15 years). This recommendation would eliminate the present-law credit recapture rules, which are a significant source of complexity for the credit.

**Rehabilitation tax credit**

The Joint Committee staff recommends that the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936 should be eliminated. Thus, the rehabilitation credit would not be a two-tier credit, but instead would provide only a 20-percent credit with respect to certified historic structures.

The recommendation would achieve simplification in two respects. First, it would eliminate the overlapping categories of “old” and “historic” buildings eligible for different levels of credit under present law. Second, it would eliminate the record-keeping burden currently imposed under the 10-percent credit.

**Orphan drug tax credit**

The Joint Committee staff recommends that the definition of qualifying expenses for the orphan drug tax credit should be expanded to include expenses related to human clinical testing incurred after the date on which the taxpayer files an application with the Food and Drug Administration for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit could only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration in accordance with section 526 of such Act. The recommendation would reduce complexity by treating all human clinical trial expenses in the same manner for purposes of the credit and any allowable deduction.

**Work opportunity tax credit and welfare-to-work tax credit**

The Joint Committee staff recommends that the work opportunity tax credit and welfare-to-work tax credit should be combined and subject to a single set of rules. The combined credit would be simpler for employers because they would use a single set of requirements when hiring individuals from all the targeted groups of potential employees.

**Indian employment credit**

The Joint Committee staff recommends that the Indian employment credit should be calculated without reference to amounts paid by the employer in 1993. Eliminating the incremental aspect of the credit would reduce the record retention burden on taxpayers in the event the credit is extended permanently.
**Reduced emissions vehicles**

The Joint Committee staff recommends that the tax benefit for reduced emissions vehicles should be a deduction of qualified expenses related to all such qualifying vehicles, provided that the Congress chooses to extend the tax benefits applicable to such vehicles. Fewer tax benefit options for a similar policy goal would simplify taxpayer decision making and promote a uniform incentive.

**8. Accounting provisions**

**Cash method of accounting**

The Joint Committee staff recommends that a taxpayer with less than $5 million of average annual gross receipts should be permitted to use the cash method of accounting and should not be required to use an accrual method of accounting for purchases and sales of merchandise under section 471. A taxpayer that elects not to account for inventory under section 471 would be required to treat inventory as a material or supply that is deductible only in the amount that it is actually consumed and used in operations during the tax year. The recommendation would not apply to tax shelters and would not alter the rules for family farm corporations. The recommendation would enlarge the class of businesses that can use the cash method of accounting, which is a simpler method of accounting. Such businesses would have reduced recordkeeping requirements and would not need to understand the requirements associated with an accrual method of accounting.

**Organizational costs**

The Joint Committee staff recommends that the rules and requirements to elect to amortize organizational costs should be codified in a single Code provision irrespective of the choice of entity chosen by the taxpayer. In addition, organizational costs incurred in the formation of entities that are, or are elected to be, disregarded for Federal income tax purposes would be eligible to recover organization costs over 60 months. The recommendation would consolidate the rules governing the treatment of organizational costs for all types of entities into one provision and would clarify the tax treatment of organizational costs incurred with respect to legal entities that are disregarded for Federal income tax purposes.

**Mid-quarter convention for depreciation**

The Joint Committee staff recommends that the mid-quarter convention for depreciable property should be eliminated. This calculation, which requires an analysis of property placed in service during the last three months of any taxable year, can be complex and burdensome because taxpayers must wait until after the end of the taxable year to determine the proper placed-in-service convention for calculating depreciation for its assets during the taxable year. The recommendation would simplify the rules for calculating depreciation, because an analysis of property would no longer need to be performed with respect to property placed in service during the last three months of a taxable year to determine application of the mid-quarter convention.
9. Financial products and institutions

Straddle rules

The Joint Committee staff recommends that the general loss deferral rule of the straddle rules should be modified to allow the identification of offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. Straddle period losses would be allocated to the identified offsetting positions in proportion to the offsetting straddle period gains and would be capitalized into the basis of the offsetting position.

The Joint Committee staff recommends that the exception for stock in the definition of personal property should be eliminated. Thus, offsetting positions involving actively traded stock generally would constitute a straddle.

Modifying the general loss deferral rule to permit identification of offsetting positions in a straddle would eliminate an additional level of complexity and uncertainty encountered by taxpayers in applying the loss deferral rules to straddles, particularly unbalanced straddles. Similarly, eliminating the stock exception would simplify the straddle rules by eliminating an exception that has become very complex in practice and only applies to a narrow class of transactions.

Interest computation

The Joint Committee staff recommends that the eight different regimes for imposing interest on deferred taxes should be consolidated into three separate regimes: (1) an annual interest charge rule; (2) a look-back rule in which estimates are used; and (3) a look-back rule in which the tax is allocated to prior years based on the applicable Federal rate. The interest rate that would be applied in connection with the three separate regimes would be a uniform rate. Consolidating the interest charge rules would reduce complexity by providing a more uniform application of rules that fulfill the same policy of imposing interest on the deferral of tax. Computing the interest charges at a uniform rate would further reduce the complexity of interest charges.

Taxation of annuities

The Joint Committee staff recommends that section 72, relating to taxation of annuities, should be redrafted to eliminate overly convoluted language and improve the readability of the statutory language. The Joint Committee staff provides a recommended redraft of a portion of section 72 for public review and comment.

In addition, the Joint Committee staff recommends that the provisions of section 72 that apply to qualified retirement plans should be separated from the other provisions of section 72 and combined with the other rules governing the taxation of distributions from such plans. The recommendations would provide simplification by improving the readability of the provisions and by grouping related provisions together so they can be more easily found and understood.
Insurance companies

The Joint Committee staff recommends that the special rules permitting a deduction for certain reserves for mortgage guaranty insurance, lease guaranty insurance, and insurance of State and local obligations should be eliminated. The recommendation would reduce complexity by eliminating tax rules that principally serve a financial accounting purpose.

The Joint Committee staff recommends that the special rules provided to Blue Cross and Blue Shield organizations in existence on August 16, 1986, should be eliminated. Appropriate rules would be provided for taking into account items arising from the resulting change in accounting method for tax purposes. Complexity would be reduced by eliminating special rules that are based on historical facts and that are of declining relevance to the tax treatment of health insurers.

The Joint Committee staff recommends that the two five-year rules relating to consolidated returns of affiliated groups including life insurance companies and nonlife insurance companies should be eliminated. Appropriate conforming rules should be provided. The complexity both to the acquired corporations and the existing members of the affiliated group in corporate acquisitions involving life insurance and nonlife insurance companies would be reduced, with respect to recordkeeping and with respect to calculation of tax liability.

10. International provisions

Foreign personal holding companies, personal holding companies, and foreign investment companies

The Joint Committee staff recommends that (1) the rules applicable to foreign personal holding companies and foreign investment companies should be eliminated, (2) foreign corporations should be excluded from the application of the personal holding company rules, and (3) subpart F foreign personal holding company income should include certain personal services contract income targeted under the present-law foreign personal holding company rules. The recommendation would provide relief from the complex multiple sets of overlapping anti-deferral regimes that potentially apply to U.S. owners of stock in a foreign corporation.

Subpart F de minimis rule

The Joint Committee staff recommends that the subpart F de minimis rule should be modified to be the lesser of five percent of gross income or $5 million (increased from the present-law dollar threshold of $1 million). For taxpayers with relatively modest amounts of subpart F income, the recommendation would provide relief from the complexity and compliance burdens involved in separately accounting for income under the subpart F anti-deferral rules.

Look-through rule for 10/50 companies

The Joint Committee staff recommends that, for foreign tax credit limitation purposes, the look-through approach should be immediately applied to all dividends paid by a 10/50 company (regardless of the year in which the earnings and profits were accumulated). The
recommendation would provide relief from recordkeeping burdens on U.S. corporations required to account for dividends paid by a 10/50 company under both the single basket limitation approach and the look-through approach.

**Deemed-paid foreign tax credits**

The Joint Committee staff recommends that a domestic corporation should be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) 10 percent or more of the foreign corporation’s voting stock. The recommendation would clarify uncertainty in the law that may exist with respect to the application of the indirect foreign tax credit rules when a partner indirectly owns an interest in a foreign corporation through a partnership.

**Section 30A and section 936**

The Joint Committee staff recommends that, if the credits under section 30A and section 936 are extended (these provisions will expire after 2005), consideration should be given to conforming the application of the credit across all possessions and to combining the rules in one Code section. The recommendation would improve the readability of the rules for potential credit claimants with operations in Puerto Rico and other U.S. possessions by consolidating similar requirements for claiming such credits in one Code section.

**Uniform capitalization rules**

The Joint Committee staff recommends that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale should be capitalized using U.S. generally accepted accounting principles for purposes of determining a foreign person’s earnings and profits and subpart F income. The uniform capitalization rules would continue to apply to foreign persons for purposes of determining income effectively connected with a U.S. trade or business. The recommendation would relieve taxpayers and the IRS from the compliance and enforcement burdens associated with applying the uniform capitalization adjustments in the context of certain foreign activities.

**Secondary withholding tax**

The Joint Committee staff recommends that the secondary withholding tax with respect to dividends paid by certain foreign corporations should be eliminated. The recommendation would spare taxpayers the burden of having to understand and comply with rules that have limited applicability, and relieve the IRS of the difficult task of trying to enforce the tax against a foreign corporation with little or no assets in the United States.

**Tax on certain U.S.-source capital gains of nonresident individuals**

The Joint Committee staff recommends that the 30-percent tax on certain U.S.-source capital gains of nonresident individuals should be eliminated. The recommendation would spare nonresident individuals with U.S. investments the burden of having to understand and comply with a rule that has limited applicability.
Treaties

The Joint Committee staff recommends that the Secretary of the Treasury should update and publish U.S. model tax treaties at least once each Congress. The recommendation would help inform potentially affected taxpayers of the Administration’s current treaty policy goals, afford affected taxpayers the opportunity to offer more helpful commentary to treaty policy makers, and enable affected taxpayers to make more informed assessments regarding investments in countries in which treaty negotiations are being carried out.

The Joint Committee staff recommends that the Treasury should report to the Congress on the status of older U.S. tax treaties at least once each Congress. The recommendation would establish a process for renewing older U.S. tax treaties that may not reflect current policy and that provide different tax outcomes than do more recent U.S. tax treaties. Timely updates of U.S. tax treaties would reduce complexity that may arise for taxpayers and tax administrators as any one taxpayer may be subject to multiple different tax regimes on otherwise similar transactions by reason of the transactions involving different taxing jurisdictions with different treaties.

11. Tax-exempt organizations

Grass-roots lobbying

The Joint Committee staff recommends that the separate expenditure limitation on grass-roots lobbying by certain tax-exempt organizations should be eliminated. Eliminating this limitation would relieve charities making the section 501(h) election of the need to define and allocate expenses for grass-roots lobbying as a subset of total lobbying expenditures. This would simplify the Code and regulations by eliminating a largely unnecessary, but burdensome, process of definition and calculation.

Excise tax based on investment income

The Joint Committee staff recommends that the excise tax based on the investment income of private foundations should be eliminated. The recommendation would relieve private foundations of having to calculate net investment income, to make estimated tax payments, and to consider whether annual charitable distributions should be increased or decreased because of the two-tiered nature of the tax. In addition, taxable foundations would not be required to calculate the unrelated business income tax they would have been required to pay if they were a taxable organization. Short of elimination, the tax could be revised to generate less revenue and at the same time become less complex, for example, by basing the tax on a percentage of the value of a private foundation’s assets at the end of a taxable year.

12. Farming, distressed communities, and energy provisions

Conservation payments

The Joint Committee staff recommends that the Code should be amended to reflect that the agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act has been replaced by the Environmental Quality Incentives Program. The
recommendation would clarify that cost-sharing payments under the Environmental Quality Incentives Program are excludable from gross income.

Reforestation expenses

The Joint Committee staff recommends that the separate seven-year amortization and tax credit for $10,000 of reforestation expenses should be replaced with expensing of a specified amount of reforestation expenses. Expensing could provide approximately the same tax benefit for qualified reforestation expenditures without requiring two distinct calculations and without requiring the additional recordkeeping to carry forward the taxpayer’s unamortized basis in the expenditures through eight taxable years.

Sales of timber qualifying for capital gains treatment

The Joint Committee staff recommends that (1) the sale of timber held more than one year by the owner of the land from which the timber is cut should be entitled to capital gain treatment and (2) the provision relating to a retained economic interest should be eliminated. The recommendation would eliminate the need to make subjective determinations of dealer status with respect to sales of timber and would eliminate a source of controversy and litigation.

District of Columbia (“D.C.”) Enterprise Zone

The Joint Committee staff recommends that, if the D.C. Enterprise Zone is to be extended for a significant period of time, then the poverty rates and the gross income thresholds applicable to the zero-percent capital gains rate should be conformed to the poverty rates and gross income thresholds that apply to the other tax incentives with respect to the D.C. Enterprise Zone. Thus, the Joint Committee staff recommends that a new business should qualify for the zero-percent capital gains rate if (1) more than 50 percent (rather than 80 percent) of its gross income is from the active conduct of a qualified business within the zone, and (2) the business is located in census tracts with at least a 20-percent (rather than 10 percent) poverty rate. The recommendations would eliminate much of the confusion, as well as traps for the unwary, for businesses that locate in the D.C. Enterprise Zone by providing a single gross income and single poverty test for determining whether a new business qualifies for the various tax incentives.

Tax incentives for business located in targeted geographic areas

The Joint Committee staff recommends that a uniform package of tax incentives for businesses that locate in targeted geographic areas should be adopted. In addition, the targeted geographic areas that would be eligible for the tax incentives would be determined based on the application of a consistent set of economic measurements. The recommendation would eliminate many of the complexities that exist under present law for businesses in determining where to locate its business facilities, and for the Treasury, the IRS, and State and local agencies in selecting the distressed areas complying with the tax laws and monitoring the effectiveness of the tax incentives.
Geological and geophysical costs

The Joint Committee staff recommends that taxpayers should be permitted immediate expensing of geological and geophysical costs. The recommendation would reduce complexity by eliminating the need to allocate such expenses to various properties and by eliminating the need to make factual determinations relating to the properties, such as what constitutes an area of interest and when a property is abandoned.

13. Excise taxes

Highway Trust Fund excise taxes

The Joint Committee staff recommends that the number of taxes imposed to finance Highway Trust Fund programs should be reduced by eliminating or consolidating the non-fuels taxes. The rates at which the fuels taxes or the restructured non-fuels taxes are imposed could be adjusted to ensure that future funding for Trust Fund programs is not affected. Adoption of this recommendation would reduce the number of taxpayers having direct involvement with the highway excise taxes. Further, the non-fuels taxes are heavily dependent on factual determinations; their elimination would end numerous audit issues between taxpayers and the IRS.

The Joint Committee staff recommends that the definition of highway vehicle should be clarified to eliminate taxpayer uncertainty about the taxability of motor fuels and retail sales (if the retail sales tax is retained). Enacting a single definition of highway vehicle would provide certainty to taxpayers.

The Joint Committee staff recommends that the option to pay the heavy vehicle annual use tax in quarterly installments should be eliminated (if that tax is retained). Elimination of this payment option would increase compliance with the highway excise taxes while eliminating the need for tracking relatively small amounts of tax due from numerous taxpayers.

The Joint Committee staff recommends that several technical modifications should be made to the present Code provisions governing motor fuels refund procedures and tax collection: (1) timing and threshold requirements for claiming quarterly refunds should be consolidated to allow a single claim to be filed on an aggregate basis for all fuels; (2) to the extent necessary to implement item (1), differing present-law exemptions should be conformed; (3) clarification of the party exclusively entitled to a refund should be provided in cases in which present law is unclear; (4) the regulatory definition of “position holder” (the party liable for payment of the gasoline, diesel fuel, and kerosene taxes) should be modified to recognize certain two-party terminal exchange agreements between registered parties; and (5) the condition of registration requiring terminals to offer for sale both undyed and dyed diesel fuel and kerosene should be eliminated. Consolidation and clarification of differing rules that affect similar transactions by taxpayers would provide certainty to taxpayers, as well as reducing needed IRS resources in administering these taxes.
Airway Trust Fund excise taxes

The Joint Committee staff recommends that liability for the commercial air transportation taxes should be imposed exclusively on transportation providers.

The Joint Committee staff recommends that the penalties for failure to disclose commercial air passenger tax on tickets and in advertising should be eliminated. Department of Transportation consumer protection disclosure requirements would remain in force for these as well as other currently regulated fees and charges.

The Joint Committee staff recommends that a uniform, statutory definition of the tax base for the commercial air freight tax should be enacted with any exclusion for accessorial ground services being specifically defined. This recommendation would provide a level playing field for all air freight carriers, and also would eliminate numerous audit disputes that occur under present law.

The Joint Committee staff recommends that the current definition of commercial air transportation, as applied to non-scheduled transportation, should be reviewed and, if appropriate, conformed to Federal Aviation Administration aircraft safety and pilot licensing regulations.

The Joint Committee staff recommends that the present-law Code provisions governing aviation fuel refund and tax collection procedures should be coordinated with comparable rules for Highway Trust Fund excise taxes, if possible.

Harbor Maintenance Trust Fund excise tax and tax on passenger transportation by water

The Joint Committee staff recommends that the Harbor Maintenance Trust Fund excise tax and the General Fund tax on passenger transportation by water should be eliminated. This recommendation would conform the Code to court decisions and U.S. international trade obligations.

Aquatic Resources Trust Fund excise taxes

The Joint Committee staff recommends that the sport fishing equipment excise tax should be eliminated. The current tax requires excessive factual determinations and disadvantages some industry participants relative to manufacturers of similar, untaxed articles that compete in the marketplace.

Federal Aid to Wildlife Fund and non-regular firearms excise taxes

The Joint Committee staff recommends that Federal Aid to Wildlife Fund and non-regular firearms excises taxes should be eliminated. If the taxes are retained, consideration should be given to (1) consolidating certain of the taxes and (2) changing the tax rates to fixed-amount-per-unit rates in lieu of the present ad valorem rate structure to reduce factual and tax-base issues arising under the current structure. Tax law simplification would be furthered if the dedicated taxes were repealed and the Wildlife Fund program financed with general revenue appropriations.
Black Lung Trust Fund excise tax

The Joint Committee staff recommends that the Code provisions on exported coal should be modified to eliminate the provisions imposing tax on coal mined for export in light of a recent court decision holding that portion of the tax to be unconstitutional.

Communications excise tax

The Joint Committee staff recommends that the present-law Federal communications excise tax should be eliminated. If the tax is not eliminated, the Joint Committee staff recommends that: (1) liability for the tax should be shifted to telecommunications service providers so that unpaid tax would be collected as part of regular bad debt collections; (2) the present Code provisions should be updated to reflect current technology; and (3) broad grants of regulatory authority should be provided to the Treasury to allow it continually to update the tax base to reflect future technological changes. Under present law, the communications tax does not reflect the state of technology in the industry, thereby giving rise to disparate treatment of different providers of similar services and requiring highly factual determinations as to when services are taxed.

Ozone-depleting chemicals excise tax

The Joint Committee staff recommends that the ozone-depleting chemicals excise tax should be eliminated as deadwood in light of provisions of the Montreal Protocol and the Clean Air Act that significantly restrict the use of the chemicals subject to tax.

Alcohol excise taxes

The Joint Committee staff recommends that the three separate excise taxes currently imposed on alcoholic beverages should be consolidated into a single tax, with the rate being based on alcohol content of the beverage. The Code provisions governing operation of alcohol production and distribution facilities similarly should be consolidated to the extent consistent with overall operation of Federal alcohol regulation laws.

The Joint Committee staff recommends that, if the current three-tax structure is retained, the reduced rates for production from certain small facilities and for distilled spirits beverages containing alcohol derived from fruit should be eliminated. This recommendation would result in identical beverages being subject to the same tax rate, thereby eliminating economic advantages that currently flow to some, but not all, producers of the same product as well as reducing recordkeeping requirements on taxpayers.

The Joint Committee staff recommends that the alcohol occupational taxes should be eliminated. These taxes are in the nature of business license fees and serve no tax policy purpose.

The Joint Committee staff recommends that the rules governing cover over of rum excise taxes to Puerto Rico and the U.S. Virgin Islands should be consolidated to reduce Federal administrative resources required for this revenue-sharing program.
**Tobacco excise taxes**

The Joint Committee staff recommends that the present excise taxes on pipe tobacco, roll-your-own tobacco, and cigarette papers and tubes should be consolidated into a single tax on pipe and roll-your-own tobacco.

The Joint Committee staff recommends that the tax rate imposed on cigars should be modified to eliminate the *ad valorem* component. Adoption of this recommendation would reduce audit issues as to the correct tax base in transactions where the products are sold between manufacturers and related parties in the distribution system.

The Joint Committee staff recommends that the tobacco occupational tax should be eliminated. This tax is in the nature of a business license fee and serves no tax policy purpose.

**14. Tax-exempt bonds**

**Unrelated and disproportionate use limit**

The Joint Committee staff recommends that the unrelated and disproportionate use limit under which no more than five percent of governmental bond proceeds may be used for a private purpose that is unrelated to the governmental activity also being financed should be eliminated. The general limits on private business use of governmental bond proceeds, combined with the requirement that certain larger issues receive an allocation of State private activity bond volume authority, adequately restrict issuance of tax-exempt governmental bonds to situations in which a private party does not receive excessive benefit.

**Prohibition on use of private activity bond proceeds for certain business**

The Joint Committee staff recommends that the prohibition on using private activity bond proceeds for certain business should be conformed for all such bonds and consolidated into one Code section. The multiple sets of rules for similar types of bonds create unnecessary complexity for taxpayers and the IRS.

**Obsolete and near-obsolete provisions**

The Joint Committee staff recommends that the special qualified mortgage bond rules for residences located in Federal disaster areas, which have expired, should be eliminated as deadwood.

The Joint Committee staff recommends that the temporary gubernatorial authority to allocate the private activity bond volume limits, which has expired, should be eliminated as deadwood.

The current qualified mortgage bond and qualified veterans' mortgage bond programs substantially overlap. The Joint Committee staff recommends that only one mortgage interest subsidy -- qualified mortgage bonds -- should be provided through the issuance of tax-exempt private activity bonds. Consolidation of two similar provisions would reduce the need for duplicate administrative agencies and eliminate potential confusion among potentially qualifying...
beneficiaries and among potential lenders in those States that issue both qualified mortgage bonds and qualified veterans’ mortgage bonds.

The Joint Committee staff recommends that the $150 million limit for qualified section 501(c)(3) bonds should be eliminated as it relates to capital expenditures incurred before the date of enactment of the Taxpayer Relief Act of 1997. This limit was repealed in 1997 for capital expenditures incurred after enactment of the Taxpayer Relief Act.

The Joint Committee staff recommends that the qualified small-issuer exception for certain bank-qualified bonds should be eliminated in light of the development since 1986 (when the rule was enacted) of State bond banks and revolving pools that provide needed market access for smaller governmental units without the bank subsidy provided by the exception. In addition, provisions of the Community Reinvestment Act now require banks to invest in local projects without regard to subsidies such as that provided by this exception. The elimination of this exception would help streamline the arbitrage rebate rules without disadvantaging qualified small-issuers.

Public notice requirement

The Joint Committee staff recommends that the “public notice” requirement for a qualified private activity bond should be allowed to be satisfied by other media if the objective of reasonable coverage of the population can be met. For example, notice via the Internet in addition to radio and television would satisfy an expanded public notice requirement. The Joint Committee staff recommends that, in lieu of a public hearing, the public comment requirement should be satisfied by written response and Internet correspondence. The recommendation would reduce the compliance burden by offering issuers less costly ways to obtain public scrutiny of proposed bond issues.

Arbitrage rebate

The Joint Committee staff recommends that the present-law construction period spend down exception should be expanded to 36 months with prescribed intermediate targets. Expanding the present-law construction period spend down exception to somewhat longer construction projects would expand the number of issuers who are not required to track temporary investments and compute arbitrage without creating excessive incentives to issue bonds in larger amounts or earlier than needed for governmental purposes in order to invest proceeds for profit.

The Joint Committee staff recommends an increase to the basic amount of governmental bonds that small governmental units may issue without being subject to the arbitrage rebate requirement from $5 million to $10 million. Specifically, these governmental units would be allowed to issue up to $15 million of governmental bonds in a calendar year provided that at least $5 million of the bonds are used to finance public schools. This recommendation reflects the increased dollar costs of activities financed by smaller governments since the provision was enacted in 1986 without expanding the benefit beyond those smaller governments that often lack in-house accounting staff to perform needed investment tracking and arbitrage calculations.
15. **Estate and gift tax**

   The Joint Committee staff recommends that the qualification and recapture rules contained in the special-use valuation and the qualified family owned business provisions be conformed to the extent practicable. Uniform rules to the extent practicable would make these related estate tax benefits easier to understand and administer.

16. **Deadwood provisions**

   The Joint Committee staff recommends that out of date and obsolete provisions in the Code should be eliminated. The Joint Committee staff has identified more than 100 provisions that could be eliminated as deadwood.