GALLIA EST OMNIS DIVISA IN PARTES TRES

By: Stefan F. Tucker

A LITTLE BIT OF BACKGROUND

I am really honored to have been invited to give the 21st Annual Griswold Lecture. Unlike a number of you older persons here, I did not know the Dean, but I do feel a connection. Dean Griswold was the Dean of Harvard Law School, and, as many of you may know, we Michigan graduates have always referred to Harvard as the "Michigan of the East."

In June, I will have practiced law for 50 years -- 1 year as a Tax Court Clerk and 49 years as a private firm attorney and I have been teaching in law school for 43 years -- first, George Washington University, then Georgetown University and now both Georgetown and Michigan.

And so, I decided this evening to focus all of us on the future --

First, the future of the legal profession and particularly tax lawyers. And I do not refer to myself as a "tax lawyer", but rather as an entrepreneur's lawyer -- with a focus on tax and a unique specialty in DC -- I represent dysfunctional families.

Second, true tax reform -- in the broadest sense.

Third, simplification of the Code -- as a start toward true tax reform.

And so -- my title is a famous saying by Julius Caesar:

"GALLIA EST OMNIS DIVISA IN PARTES TRES"

"ALL OF GAUL IS DIVIDED INTO THREE PARTS"

I. TAX COUNSEL: THE FUTURE OF OUR PROFESSION

"Cogito, ergo sum." ("I think; therefore I am.") R. Descartes, Discourse on Method

A. LAWYERS: PROFESSIONALS OR BUSINESS PERSONS? OR BOTH?

1. How many "partners" are in fact only employees at will? What if there are not enough client hours, billings and/or client ties?

(a) See "What Law School Doesn't Teach you … But You *Really* Need to Know", by Kimm Alayne Walton, published by Harcourt in 2000.

(b) Chapter Two is captioned "ECON-101 -- The Business of Law" and makes the following points for law students, which are lessons for all:

(i) As in all businesses, the people who bring in the business are worth more than the people who do the work.

(ii) Your firm has to make money on you to justify what they pay you.

(iii) Billable hours count more than non-billables, no matter what the party line is.

(c) Also, see the piece captioned "Layoffs Threaten Law Firm Partners, by J. Smith, on page B1 of the January 7, 2013 issue of <u>The Wall Street Journal</u>.

(i) Focusing on Waller Lansden (which is our good friend Leigh Griffith's firm), the piece notes that, "When the recession caused business to sag, the Nashville, Tenn. firm overhauled its partnership structure. Managers recalibrated pay and assigned specific hour and revenue goals to partners at the 200-lawyer firm. 'Over that time [the firm] went from almost 85 equity partners to about 55. *** [There were] a lot of hard conversations, and so some people left ….' Those who stayed 'became more engaged on developing new lines of business.'"

(ii) "Even before the downturn, some law firms were starting to trim low performers. For many firms, selective partner culls [became] "good housekeeping". This new round of cuts comes as productivity among the highest-paid tier of a firm's lawyers remains stubbornly low, with some partners billing less than 1,300 hours a year, down about 30% from the prerecession industry benchmark of 1,900 hours."

2. In today's world, how do we assure our survivability in the average law firm? As a specialist, or as a generalist, or as more than a "tax lawyer"?

(a) To quote Paul Sax, in his piece titled "Prepare for Change" for <u>Careers in Tax Law</u>, noted below, "Rarely mentioned among lawyers is the regularity with which we are required to refit, retool, and recommence in order to maintain ourselves in our careers. *** Law firms disappear with frightening suddenness."

(b) Paul goes on to say: "How to prepare? Don't overspecialize. Keep several subspecialties going at all times. *** Be proactive in seeking out new opportunities. There is always room for the new, the interesting, the different.

3. Will all, or many, benefits go the way of the sabbatical?

B. <u>THE ROLE OF "TAX COUNSEL"</u>

1. difference between the entrepreneur and the public entity as the client

(a) also, going in-house

(b) working in the non-profit environment

(c) working with low-income taxpayers

(d) working in the government

(e) See, generally, Careers in Tax Law: Perspectives on the Tax Profession and What It Holds for You, published by the ABA Tax Section in 2009, in which a number of persons here this evening have written pieces.

2. as to entrepreneur

(a) center

(b) but part of a team with

(i) accountant

(ii) in-house counsel

(iii) wealth advisor/investment advisor

(iv) family office, if applicable

(v) counselor/social worker/psychologist

3. As to public company

(a) Specialist, but aware of add-ons, based on other needs

4. Client's partner - figuratively

C. THE NEED FOR "BUSINESS ACUMEN" AND "COMMON SENSE"

1. In a recent study by UC Berkeley Professors Schultz and Zedeck, captioned "Identification, Development and Validation of Predictions for Successful Lawyering", 26 competencies were identified as forming the basis for effective lawyering. These competencies were placed into 8 different categories, as follows:

(a) Intellectual and cognitive

(b) Research and gathering

(c) Communications

(d) Planning and organizing

(e) Conflict resolution

(f) Client and business relations – entrepreneurship

(g) Working with others

(h) Character

2. Of the 26 competencies, only a few could be seen as tying success to the traditional factors used by many law firms to determine who will be hired (and thus who is likely to succeed at the firm). These are:

(a) Researching the law

(b) Analysis and reasoning

(c) Writing

3. The bulk of the other competencies focus on business acumen, common sense and networking. These include:

(a) Intellectual and cognitive

(i) Creativity/innovation

(ii) Problem-solving

(iii) Practical judgment

(b) Research and gathering

(i) Questioning

(ii) Interviewing

(c) Communications

(i) Influencing and advocating

(ii) Listening

(d) Planning and organizing

(i) Strategic planning

(ii) Organizing and managing one's own work

(e) Conflict resolution

(i) Negotiation skills

(ii) Able to see the world through the eyes of others

(f) Client and business relations -- entrepreneurship

(i) Networking

(ii) Providing advice and counsel

(iii) Building relationships with clients

(g) Character

(i) Passion and engagement

(ii) Integrity/honesty

(iii) Stress management

(iv) Community involvement and service

(v) Self-development

4. As noted in an excellent article in the July 2012 issue of the ABA Journal, captioned "The Pedigree Problem: Are Law School Ties Choking the Profession", by IU Prof. Henderson and Ms. Zahorsky of the ABA Journal, as the law profession undergoes major structural transformation, it needs better to assess hiring from law schools.

(a) Too great a weight is placed on academic pedigree, tied to law school rankings (and for many that is the U.S. News and World Report ranking). Such rankings stress:

(i) LSAT scores

(ii) Undergraduate GPAs

(b) More weight should be placed on the competencies noted and the ability of newer lawyers to reflect those competencies.

D. MENTORS TO THE NEXT GENERATION

1. Are we truly sharing our knowledge and experience with younger persons?

(a) Are we helping them to learn and, hopefully, grow?

(b) At such groups as Tax Section, state or local bar associations, do we key in on persons to bring forward?

(c) Are we networking?

(d) Do we encourage calls from others for information and advice?

2. Are we teaching in law schools, business schools or elsewhere?

(a) Is there value to an LLM in Tax?

(b) If so, is it more or less valuable than an MBA?

(c) Is it more or less valuable than learning on the job?

(d) Should there be more “practical” courses and less theoretical in the LLM and/or undergraduate law programs?

3. As previously noted, law firms are downsizing or basically not growing

(a) In that light, how do we attract the best persons to our profession?

(b) Who do we want to attract? How do we compete with the accounting firms or the in-house positions for the top persons, either initially or after the “mid-life crisis” at the law firm – 4 or 5 years after joining?

4. Are we losing a lot of the cream to accounting firms or in-house positions?

(a) Hours

(b) Marketing

(c) Billings

II. <u>TAX SIMPLIFICATION OF THE CODE FOR THE ENTREPRENEUR, WHETHER OR NOT "SMALL BUSINESS</u>

> "The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing." J.B. Colbert, Louis XIV's Controller-General of Finance

A. OVERRIDE -- How do we influence Congress, on a Senator-by-Senator or Congressman-by-Congressman basis? Does anyone out there with influence listen to us on these basic issues of simplification and/or tax reform, which are not necessarily the same?

B. SECOND OVERRIDE -- Entrepreneurs are particularly concerned with four issues –

1. Growing their businesses – specifically, access to capital and capital formation;

2. Protecting their assets from business risks;

3. Protecting their businesses and personnel from adversity; and

4. Business succession.

C. TAX POLICY IMPLICATIONS -- All of these concerns are impacted by Federal tax policy, as well as – but to a lesser extent – state and local tax policy

1. The business can be formed in, illustratively, Delaware or Nevada, rather than New York or California

2. Manufacturing or service providers over the internet or telephone can be moved from a fixed union dues state to a right-to-work state. For example, a number of call-in centers are based in South Dakota or Florida because of the costs of personnel and absence of state income tax (on compensation, but not interest or dividends, in South Dakota); and, increasingly, these "centers" are in fact simply being based in the homes of the persons – working stay-at-home parents, disabled persons and the like.

As the world gets smaller, because of the speed of communications and the quality and speed of transportation, this mobility has happened, and will continue to happen, at the national level, moving out of the U.S. to other countries, near (such as Mexico) or far (such as Sri Lanka). And moving from one country to another, such as from Japan to China to Sri Lanka for manufacturing; and from India to the Philippines for call-in centers for U.S.-based companies, such as United Airlines.

D. TAX RATES AND THE ECONOMY.

1. On September 14, 2012, the Congressional Research Service issued a Report captioned "<u>Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since</u>

1945". This Report was withdrawn in late November 2012, apparently for politically motivated reasons.

2. As pointed out in the Report's Summary, "Advocates of lower tax rates argue that reduced rates would increase economic growth, increase saving and investment, and boost productivity (increase the economic pie). Proponents of higher tax rates argue that higher tax revenues are necessary for debt reduction, that tax rates on the rich are too low (i.e., they violate the Buffett rule), and that higher tax rates on the rich would moderate increasing income inequality (change how the economic pie is distributed)."

3. The Report's Summary went on to note: "Throughout the late 1940s and 1950s, the top marginal tax rate was typically above 90%; today it is 35%. Additionally, the top capital gains tax rate was 25% in the 1950s and 1960s, 35% in the 1970s; today it is 15%. The real GDP growth rate averaged 4.2% and real per capita GDP increased annually by 2.4% in the 1950s. In the 2000s, the average real GDP growth rate was 1.7% and real per capita GDP increased annually by less than 1%."

4. The Report's Summary then reached the following conclusions:

(a) "There is not conclusive evidence…to substantiate a clear relationship between the 65-year steady reduction in top tax rates and economic growth."

(b) "Analysis of such data suggests the reduction in the top tax have had little association with saving, investment, or productivity growth."

(c) "However, the top tax rate reductions appear to be associated with the increasing concentration of income at the top of income distribution. The share of income to the top 0.1% of U.S. families increased from 4.5% in 1945 to 12.3% by 2007.…"

(d) "The evidence does not suggest necessarily a relationship between tax policy with regard to the top tax rates and the size of the economic pie, but there may be a relationship to how the economic pie is sliced."

E. CHOICE OF ENTITY: A TAX NEUTRAL PROPOSAL

1. On March 7, 2012, I testified before the House Ways & Means Committee on the treatment of closely held businesses in the context of tax reform. The following were my suggestions at the Hearing.

2. Single tax entity

(a) Elective

(b) Irrespective of form

(c) Corporation

(i) No distinction between C or S corporation

(ii) Too many problems with S corporation -- 5 footfaults, as follows:

(A) 100 shareholders limit

(B) Type of shareholder

(C) Two classes of stock

(D) Basis

(E) No Sec. 754

(iii) Thus, all are simply corporations

(d) Partnership – LLC, LP, GP, LLP, etc.

(e) The governance would be Subchapter K, eliminating the need for Subchapter S

(f) All income passed through

(g) Immediate deduction for all capital expenditures, with two-year carry back and 20-year carry forward (effectively, as an NOL)

(h) Losses passed through only to extent of "basis", which is comprised of:

(i) Capital contributions to entity

(ii) Loans to entity

(iii) Loans of entity – recourse vs. nonrecourse

(i) Would leave entrepreneur to decide on the choice of entity based on non-tax considerations, such as state law issues

(i) state taxes

(ii) piercing the corporate veil

(iii) strict liability on certain issues

(iv) corporate formalities vs. LLC or partnership informality

(v) state corporate law capital impairment issues

(j) Anyone who works for the entity, and is an owner, irrespective of his or her percent of ownership, would be subject to withholding, FICA and FUTA, and receive a W-2, not a 1099

(k) No reasonable compensation issues, inasmuch as all taxable income would pass through to the entity owners

(l) Provide a reasonable grace period to make decision, such as in TRA 1986, when General Utilities was eliminated and could convert from C corporation to S corporation without a built-in gain issue.

3. Double tax entity

(a) Elective

(b) Irrespective of form –

Corporation or partnership

(c) Entity level tax – 35%

(d) Tax on dividends - 20% to 23.8% (or, if lower income, 15% to 18.8%)

(e) Dividends paid deduction for current earnings paid out to owners (similar to current taxation of REITs, but without the requisite distribution requirements), and the owners would be taxed on such current-earnings dividends at ordinary income rates, not capital gains

(f) To the extent that income is retained rather than paid out as dividends, the following would apply:

(i) If the retained income is used to acquire tangible assets used in the trade or business within the US, the cost basis of the assets would be depreciable over the shorter of (x) 5 years or (y) their current useful lives, thereby giving an inducement to grow the business within the US.

(ii) If the retained income is used to acquire intangible assets or to acquire tangible assets used in the trade or business outside the US, the cost basis would be depreciable over the current established useful lives under the Code.

(iii) If the retained income is later distributed, there would be no dividends paid deduction, and such income would be taxed to the owners at the capital gains rates.

(g) No “golden parachute” (Sec. 162(m)(4)(C)) or other issues (such as 409A), leaving concerns as to executive compensation in the hands of the entity owners, who are directly affected by such issues. These provisions are so complex that, as noted in a thoughtful article in Tax Notes on July 30, 2012, captioned "Buried in Red Tape: How Congress Got Employee Comp Wrong", Daniel Willingham noted several criticisms, including the following:

(i) "Congress has a track record of addressing concerns with the tax code by dumping in useless red tape. This red tape comes in the form of more provisions, additional restrictions, and messier oversight measures."

(ii) Sec. 409A "was a direct response to compensation scandals with non-qualified stock options (NQSOs) at Enron, World Com, and some others. *** Given the environment of the corporate world at the time, Congress had to do something. Unfortunately, it chose to add a gauntlet of new requirements that makes the complexity of non-qualified plans comparable to qualified plans."

(iii) To prevent corporations from paying excessive compensation, "Congress passed an unnecessary piece of legislation in section 162(m)(4)(C). This put new bureaucratic procedures in place to prevent excessive compensation. However, the IRS's enforcement of section 162(m)(4)(C) shows that despite creating more hassle for employers to administer compensation plans, it provides no additional protection."

F. COMBINE WITH SIMPLIFICATION IN CERTAIN RESPECTS

1. Debt vs. Equity

(a) Simpler for single tax entity

(b) More complex for double-tax entity

(c) Note that Sec. 385 has no Regulations, although enacted as part of the Tax Reform Act of 1969, effective December 31, 1969.

(i) Treasury tried twice, but dropped the attempt when it was realized by the top tax officials (Buck Chapoton and David Glickman) that the Proposed Regulations were far too complex for all but the Fortune 1000.

(ii) Accordingly, must rely on case law, as most exhaustively articulated by Prof. Plumb, in his seminal article captioned: The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L.Rev. 369 (1971).

2. Business loss vs. Investment loss

G. OTHER THOUGHTS

1. Estate, gift and GST taxes

(a) Make state estate tax a credit up to 5% of Federal estate tax

(i) No credit or deduction above that

(ii) Could compel states to rethink their estate tax rates, or risk losing residents to lower or no estate tax states.

(A) Illustratively, moving residence (and domicile) from New York City to Florida can reduce both state income taxes and state estate taxes, inasmuch as Florida has neither.

(B) Likewise, moving from D.C. or Maryland to Virginia will significantly lower state income taxes and reduce state estate taxes from up to 16% (or higher in Maryland if the beneficiary is not in the direct line of ancestors or descendants) to zero.

2. Certainty

(a) Eliminate the "extenders", as to which the American Taxpayer Relief Act of 2012 dealt with 43 individual tax extenders, business tax extenders and energy tax extenders, temporarily extending 41 of these and permanently extending two (of which the AMT relief was by far the most significant).

(i) The above 43 extensions did not include Medicare and other health extensions or the unemployment compensation and benefits extensions.

(ii) Taxpayers should not have to go through the annual or biannual pain on these extenders, nor should the Budget or the IRS be subject to these vagaries and the consequences of late or no extension of some or all.

III. TAX REFORM RE: THE INDIVIDUAL

"Don't tax you; don't tax me; tax the man behind the tree." Sen. Russell Long, Chair, Senate Finance Committee

A. EMPLOYER-SPONSORED HEALTH INSURANCE (Sec. 106)

1. The exclusion of employer contributions for medical care and medical insurance premiums is the single largest tax expenditure for the Federal budget for fiscal years 2013-2017. According to the Congressional Budget Office ("CBO"), the exclusion of employers' contributions for health care, health insurance premiums and long-term care insurance premiums (including effects on payroll taxes) is projected to equal 1.8% of the GDP over the next 10 years.

(a) The Office of Management and Budget ("OMB") estimates that the exclusion of employer contributions for medical care and medical insurance premiums will generate the following tax expenditures:

(i) $180.58 billion in 2013,

(ii) $189.67 billion in 2014,

(iii) $200.64 billion in 2015,

(iv) $213.62 billion in 2016, and

(v) $227.81 billion in 2017.

(b) The OMB estimates that the exclusion's effect on payroll tax receipts will be an additional $113.69 billion in 2013, $117.16 billion in 2014, $122.26 billion in 2015, $129.28 billion in 2016 and $136.76 billion in 2017.

(c) The OMB estimates that the exclusion of employer contributions for medical care and medical insurance premiums will generate aggregate tax expenditures of more than $1.0 trillion for 2013 through 2017.

2. Because the exclusion of premiums for employer-sponsored health insurance reduces taxable income, it is worth more to taxpayers in higher income tax brackets than it is to those in lower income tax brackets.

3. For individuals who do not receive employment-based health coverage, total qualified health care expenses (other than health savings accounts or ("HSAs") or Archer medical savings accounts ("Archer MSAs")) are deductible only if such expenses exceed 7.5% of their adjusted gross income.

4. Proposed Tax Policy Changes.

(a) The Simpson-Bowles National Commission on Fiscal Responsibility and Reform ("Simpson-Bowles") would cap the exclusion from income under Sec. 106 at the 75th percentile of premium levels in 2014, with the cap frozen in nominal terms through 2018. The exclusion would gradually be phased down and eventually eliminated by 2038.

(b) The Bipartisan Policy Center Report under the co-chairmanship of Pete Domenici and Alice Rivlin (the "Bipartisan Report") would cap the exclusion at the 75th percentile of premium levels (with amounts above that threshold subject to tax) in 2018 and would reduce the exclusion by 10% annually until it is fully eliminated in 2028.

5. **MY PROPOSAL**: **DELETE** Sec. 106 from the Code and **TAX** employer-sponsored health insurance to the recipient/employee as income, but **DEDUCTIBLE AS ITEMIZED DEDUCTIONS** under Sec. 213 (and thus (a) only to extent such expenses exceed 10% of AGI and (b) subject to PEP and Pease overrides).

B. MORTGAGE INTEREST DEDUCTION (Sec. 163(h))

1. The deductibility of mortgage interest on owner-occupied homes is the second largest tax expenditure for the Federal budget for fiscal years 2013-2017. According to the CBO, the tax expenditures for that deduction are projected to equal 0.8% of GDP over the next 10 years.

(a) The OMB estimates that the deductibility of mortgage interest on owner-occupied homes will generate the following tax expenditures:

(i) $100.91 billion in 2013,

(ii) $100.83 billion in 2014,

(iii) $120.24 billion in 2015,

(iv) $130.92 billion in 2016, and

(v) $143.52 billion in 2017.

(b) Because the deduction for mortgage interest reduces taxable income, it is worth more to taxpayers in higher income tax brackets than it is to those in lower income tax brackets. According to the Urban Institute and the Taxpayer Center in "Reforming the Mortgage Interest Deduction", dated April 2010, the "mortgage interest deduction mainly benefits homeowners in the top fifth of the income distribution because it is only available to those who itemize deductions on their tax returns and is worth more to itemizing taxpayers in higher tax brackets".

2. Proposed Tax Policy Changes.

(a) Simpson-Bowles would limit the amount of deductible interest to the amount incurred on the first $500,000 of debt on a primary residence and replace the itemized deduction with a nonrefundable tax credit equal to 12% of eligible home mortgage interest. The credit would not be available for mortgage interest on a secondary residence or from a home equity loan.

(b) The Bipartisan Report would replace the mortgage interest deduction with a 15% credit for home mortgage interest expenses on a principal residence, up to $25,000. Instead of filing a tax return to claim the deduction, under the Bipartisan Report mortgage lenders would apply for a tax credit, which would be passed through to homeowners as a 15% reduction in their home mortgage interest payments.

3. **MY PROPOSAL**:

(a) **LIMIT THE DEDUCTION** for interest on "acquisition indebtedness" under Sec. 163(h)(3)(B) to such indebtedness equal to the lesser of (a) $500,000 or (b) one-half of the debt incurred in acquiring, constructing or substantially improving the qualified residence. (A married couple filing separate returns would each reach one-half of the limit.)

(b) **LEAVE** the "home equity indebtedness" interest deduction under Sec. 163(h)(3)(C) intact.

(c) **LEAVE** the current AMT deduction rules intact, so that the interest on acquisition indebtedness is deductible, but the interest on home equity indebtedness is not.

C. CONTRIBUTIONS TO DEFINED CONTRIBUTION PLANS AND OTHER QUALIFIED DEFERRED COMPENSATION PLANS

1. These types of deferred compensation plans are the third largest expenditure for the Federal budget for fiscal years 2013-2017.

(a) The OMB estimates that these types of plans will generate the following tax expenditures:

(i) $72.74 billion in 2013,

(ii) $81.03 billion in 2014,

(iii) $86.74 billion in 2015,

(iv) $92.23 billion in 2016, and

(v) $96.02 billion in 2017.

(b) The OMB accounts for two components of the total tax expenditure on this preference – (i) the failure of the government to collect income taxes on the labor compensation placed in employee pension accounts, and (ii) the failure to collect income taxes on the investment income earned by pension accounts. After estimating these two items, the OMB subtracts income collected on money that is withdrawn from these types of plans.

2. Proposed Tax Policy Changes.

(a) Simpson-Bowles would cap the exclusion from income tax for retirement-plan contributions at $20,000 a year or 20% of compensation, whichever is less.

(b) The Bipartisan Report would provide a flat 15% refundable tax credit (for those in lower tax brackets) for retirement contributions or a deduction (for those in higher brackets) for contributions to retirement saving accounts up to 20% of earnings or a maximum of $20,000.

3. Defined contribution plans (such as 401(k) plans, 403(b) plans, 457 plans and SEPPs) are in fact savings plans, subject ultimately to income tax on withdrawals and potential estate tax on death.

4. **MY PROPOSAL**:

(a) **ELIMINATE** all of the complexity, and **SIMPLY LIMIT** the annual contribution exemption under Sec. 415(c) to 20% of employee compensation income.

(b) Utilize the **SAME LIMITATION** for defined benefit plans under Sec. 415(b).

(c) **ALLOW** the same percentage to apply to IRAs under Sec. 219, but as a deduction not subject to PEP or Pease and over-and-above the standard deduction if used.

(d) The 20% of employee compensation limitation would be an **AGGREGATE LIMITATION** for all deferred compensation plans, not a per plan limitation.

D. STATE AND LOCAL TAXES (Secs. 164(a)(1)-(3) and (b)(5))

1. The deduction for non-business state and local taxes, other than on owner-occupied homes, is the eighth largest tax expenditure for the Federal budget for fiscal years 2013-2017. According to the CBO, the tax expenditures for such deduction are projected to equal 0.3% of GDP between 2013 and 2022.

(a) The OMB estimates that the deduction of non-business State and local taxes, other than on owner-occupied homes, will generate the following tax expenditures:

(i) $46.26 billion in 2013,

(ii) $56.98 billion in 2014,

(iii) $60.50 billion in 2015,

(iv) $63.88 billion in 2016, and

(v) $67.43 billion in 2017.

(b) Because the deduction of non-business state and local taxes reduces taxable income, again it is worth more to those in higher income tax brackets than to those in lower income tax brackets.

2. The deduction for state and local property taxes on owner-occupied homes is the 16th largest tax expenditure for the Federal budget for fiscal years 2013-2017.

(a) The OMB estimates that the deduction of State and local property taxes will generate the following tax expenditures:

(i) $22.32 billion in 2013,

(ii) $27.90 billion in 2014,

(iii) $29.06 billion in 2015,

(iv) $30.08 billion in 2016, and

(v) $31.27 billion in 2017.

(b) The OMB estimates that the deduction of state and local property taxes on owner-occupied homes will generate expenditures of about $140.63 billion in 2013 through 2017.

3. For AMT purposes, the deduction for non-business state and local income and property taxes is scaled back or eliminated. According to the Tax Policy Center, the deduction is the largest single AMT preference item (a deduction allowed under the regular income tax but not under the AMT). It accounted for more than 60% of the dollar value of all preferences in 2005. Therefore, for many higher-income taxpayers, the value of the deduction is limited.

4. <u>Proposed Tax Policy Changes</u>.

(a) Simpson-Bowles would eliminate all itemized deductions (including the state and local tax deduction), so that all individuals take the current standard deduction for non-itemizers and personal and dependent exemptions.

(b) The Bipartisan Report would eliminate the standard and itemized deduction (including the State and local tax deduction). It would replace all itemized and standard deductions with a 15% credit for home mortgage interest, capped at $25,000, and a 15% credit for charitable contributions.

[As an aside, I do not believe that these proposals recognize the increased burdens placed on the states as the Federal Government reduces its spending on discretionary items, such as education and infrastructure.]

5. **MY PROPOSAL**:

(a) **LIMIT** the aggregate deduction under Secs. 164(a)(1)-(3) and (b)(5) for all state and local taxes that are not related to the taxpayer's trade or business to the **GREATER** of (x) a maximum dollar amount limit added to the standard deduction for those taxpayers who utilize it (such as $10,000 for married taxpayers filing a joint return, one-half of that for a married taxpayer filing a separate return or $7,500 for an individual taxpayer) or (y) 6% of adjusted gross income for the taxpayer using itemized deductions.

(b) **DO NOT ALLOW** the deduction for non-business state and local taxes to push the taxpayer into the AMT.

E. CHARITABLE CONTRIBUTIONS (Sec. 170)

1. As actions and reactions occur in times of war, national tragedy or other bad-to-terrible times, the charitable contribution first came into the law as part of the War Revenue Act of 1917. As one Senator noted: "Usually people contribute to charities and educational objects out of their surplus. *** After they have done everything else they want to do, after they have educated their children and traveled and spent their money on everything they really want or think they want, then, if they have something left over, they will contribute it to a college or to the Red Cross or for some scientific purposes."

(a) Under Sec. 170(c)(2)(D), no part of the net earnings is supposed to inure to the benefit of any private shareholder or individual.

(b) In today's world, does this square with the "buying" of seats or boxes at college football stadiums or similar situations?

2. The deductibility of charitable contributions, other than for education and health, is the ninth largest tax expenditure for the Federal budget for fiscal years 2013-2017. According to the CBO, the tax expenditures for such deduction are projected to equal 0.3% of GDP between 2013 and 2022.

(a) The OMB estimates that the deductibility of charitable contributions, other than for education and health, will generate the following tax expenditures:

(i) $39.77 billion in 2013,

(ii) $43.90 billion in 2014,

(iii) $47.80 billion in 2015,

(iv) $51.66 billion in 2016, and

(v) $55.59 billion in 2017.

(b) The current rule as to the full fair market value of the appreciable securities or other property being allowed as the charitable contribution without any gain recognition on the contributed asset's fair market value in excess of basis is highly favorable to higher income tax bracket taxpayers.

3. Proposed Tax Policy Changes.

(a) Simpson-Bowles would allow taxpayers to claim a non-refundable charitable contribution credit equal to 12% of their donation, subject to a 2% AGI floor.

(b) The Bipartisan Report would eliminate all itemized deductions and standard deductions. It would replace the charitable contribution deduction with a 15% credit for charitable contributions.

4. **MY PROPOSAL**: **LIMIT** the deductibility for all charitable contributions as follows:

(a) **CASH** -- the current 50% and 30% rules;

(b) **APPRECIATED PUBLICLY TRADED SECURITIES** -- under the current 30% and 20% rules, but limited to the current fair market value less the Federal income tax (capital gain or ordinary income) that would have been imposed if sold at its fair market value on the date of such contribution; and

(c) **ALL OTHER APPRECIATED TANGIBLE OR INTANGIBLE PROPERTY** -- under the current 30% rule, the lower of adjusted basis or fair market value, except that, if given to a public charity in furtherance of its purpose or function constituting the basis of its exemption under Sec. 501, the current fair market value less the Federal income tax (capital gain or ordinary income) that would have been imposed if sold at its fair market value on the date of such contribution.

F. INTEREST ON STATE AND LOCAL BONDS (Secs. 103 and 141-147, and, for this purpose, Sec. 57(a)(5))

1. The exemption of interest on state and local bonds is the 10th largest tax expenditure in the Federal budget for fiscal years 2013-2017.

(a) The OMB estimates that the exemption of interest on state and local bonds will generate the following tax expenditures:

(i) $36.21 billion in 2013,

(ii) $42.77 billion in 2014,

(iii) $46.92 billion in 2015,

(iv) $49.57 billion in 2016, and

(v) $52.03 billion in 2017.

(b) As one can easily understand, this exception weighs heavily in favor of the top-bracket individual taxpayers.

2. Proposed Tax Policy Changes.

(a) Simpson-Bowles recommended repeal of the exemption for interest on newly issued state and local bonds.

(b) The Bipartisan Report recommended maintaining the exemption on public purpose state and local bonds.

3. A number of articles and papers have discussed the pros and cons for the exemption of state and local bond interest.

(a) On the one hand, the National Association of Bond Lawyers has made the following arguments, among others:

(i) The exemption helps lower the cost of capital funding for state and local governments.

(ii) State and local governments provide funding for critical infrastructure, such as roads and highways, bridges, airports and water and sewer facilities.

(iii) Changes to the exemption will increase state and local borrowing costs, which will be passed on to the public.

(b) On the other hand, the following have countered with a call to reduce significantly or eliminate the exclusion:

(i) The Center for American Progress noted that, because of the way the bonds are issued, 20% of the benefit from the exemption unintentionally leaks to bond buyers from higher-income tax brackets. The Center explains that this occurs because there are not enough top-bracket investors to absorb all the bonds governments want to sell, and so the issuers have to increase the interest payments to appeal also to lower-bracket investors. Such boost of tax-free interest income generates a windfall only for the wealthiest investors.

(ii) The Tax Foundation made the same argument years ago.

4. Contrast the now-expired Build America Bonds, which came into the law in 2009 and was applicable to bonds meeting the criteria of Sec. 54AA and issued before January 1, 2011. Under the Build American Bond Program, the Federal government directly subsidized a portion of the interest cost.

(a) This assured that 100% of the Federal subsidy benefitted the state and local governments, with none benefitting top-bracket taxpayers.

(b) The Program expanded the municipal bond market to a broader pool of investors at a time when, because of the recession, demand for tax-exempt bonds was weak.

(c) The Program was estimated to save state and local governments $12 billion on bond issuances during the Program's existence.

5. **<u>MY PROPOSAL</u>**:

(a) For a five-year period, **LIMIT THE EXEMPTION** for state and local bond interest as follows:

(i) **100%**, reducing by 20 percentage points each year, exemption for public infrastructure, including those facilities which are set forth in Sec. 142(a), such as airports, docks and wharves, mass commuting facilities and sewage facilities;

(ii) **50%**, reducing by 10 percentage points each year, exemption for public institutions, such as community colleges and public universities; and

(iii) **NO EXEMPTION** for any other purposes, such as professional football stadiums, professional basketball arenas, performing arts facilities and the like.

(b) **AFTER FIVE YEARS**, completely eliminate the exemption for state and local bond interest.

(c) Make all tax-exempt interest a **TAX PREFERENCE** for AMT purposes, rather than the current limitation on the preference to specified private activity bonds.

G. <u>RENTAL VALUE OF PARSONAGES</u> (Sec. 107)

1. Although not in the top 20 of tax expenditure costs, it is still a major cost. The OMB estimates that the parsonage exclusion will generate the following tax expenditures:

(i) $770 million in 2013;

(ii) $830 million in 2014;

(iii) $900 million in 2015;

(iv) $970 million in 2016; and

(v) $1.05 billion in 2017.

2. This concept was first enacted into the Code in the Revenue Act of 1921 to benefit "ministers of the gospel", and thereby indirectly benefit the religious institution itself.

(a) When this provision came into the Code in 1921, it was not controversial, notwithstanding the Constitutional mandate to separate church and state.

(b) In the early 20th Century, there was a general preference to avoid taxing clergy.

3. In the 1954 Code, the exclusion for "the rental value of a home" was broadened to include a "rental allowance paid … as part of … compensation."

(a) The purpose of the broader language was to eliminate unfairness to those ministers who were not furnished a parsonage, but received larger (taxable) salaries to compensate them for the expenses they incurred in supplying their own homes.

(b) The sponsor of such legislation stated "Certainly, in these times when we are being threatened by a godless and antireligious world movement we should correct this discrimination against certain ministers of the gospel who are carrying on such a courageous fight against this foe. Certainly this is not too much to do for these people who are caring for our spiritual welfare."

4. There is no definition of a "minister of the gospel" in the Code or the Regulations.

(a) The term "gospel" has certain implications.

(b) The focus of the Regulations is on "duties of a minister" and includes "the performance of sacerdotal functions, the conduct of religious worship, the administration and maintenance of religious organizations and their integral agencies, and the performance of teaching and administrative duties at theological seminaries."

5. In light of Sec. 170 of the Code, and further in light of the extraordinary incomes of some "ministers of the gospel", this exclusion should be eliminated, or, at the least, limited to a standard rental value based on the geographic area (broader than the zip code), with a CPI adjustment.

6. **MY PROPOSAL**: **DELETE** Sec. 107 from the Code, or, at the least, **LIMIT** this to a standard rental value based on the geographic area (broader than the zip code), with a CPI adjustment.

H. LOSS ON SALE OF PERSONAL RESIDENCE

1. Under Sec. 121, on the sale of a principal residence the gain in excess of $250,000 (or $500,000 for a married couple meeting the conditions of Sec. 121(b)(2)(A)) is subject to taxation as a capital gain.

2. However, there is no provision in the Code allowing a capital loss on the sale of the principal residence at a price below basis. In furtherance of the disallowance of a capital loss on such sale, Reg. Sec. 1.165-9(a) prohibits the deduction of losses on such sale.

(a) Historically, the first definition of a "capital asset" was enacted in the Revenue Act of 1921, and applied to property acquired and held by the taxpayer either for profit or for investment for more than two years. Such definition excluded personal use assets and stock-in-trade or inventory.

(b) In the Revenue Act of 1924, the definition of a capital asset was modified by eliminating the requirement of profit or investment and the exclusion of personal property.

(c) The Revenue Act of 1934 further modified the capital asset definition, but did not modify the ability to take capital asset treatment on personal property such as a personal residence.

(d) In Starker v. U.S., 44 AFTR 2d 79-5525 (9th Cir. 1979), the Ninth Circuit disallowed a loss on the sale of a personal residence, noting that "It has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment. Losses on the sale or exchange of such property cannot be deducted for this reason…."

(e) Contrast the loss on a loan made to a friend, which is treated as a capital loss under Sec. 166(d), or a casualty loss on a house, which is treated as a capital loss under Sec. 165(c)(3) (subject to the limits of Sec. 165(h)).

3. In contrast, note the following:

(a) Sec. 1033(h)(1) allows gain on conversion of the property via a casualty loss in a Federally declared disaster area to be deferred and reinvested in property similar or related in service or use to the residence so converted within 4 years.

(b) Sec. 108(h) allows income on the reduction of qualified principal residence indebtedness of up to $2,000,000 (for a joint return) or $1,000,000 (for a married individual filing a separate return) to be excluded from gross income to the extent that the basis of the principal residence is reduced, but not below zero. Such exclusion may only be utilized if the loan was reduced by reason of a decline in the value of the residence or the financial position of the taxpayer.

4. **MY PROPOSAL**: **ALLOW** a capital loss on the sale of the principal residence where the loss exceeds 10 percent of the adjusted basis.

I. COLLECTIBLES GAIN AND LOSS (Secs. 1(h)(4) and (5))

1. For many persons today, their principal investments are not in marketable securities or real estate, but rather in collectibles.

2. Under current law, the aggregate tax on the sale of a collectible held for more than one year would be 31.8%, whereas the aggregate tax on other capital assets, such as securities or land, held for more than one year would be 23.8% (or 25% less).

3. **<u>MY PROPOSAL</u>**: **MAKE** the long-term capital gain on a collectible the same as on any other capital asset.

IV. CONCLUSION

"Where are we going? We don't know. When will we get there?
We ain't certain. All that we know is that we are on our way."
Lerner and Loewe, Paint Your Wagon

A. THE ABOVE ITEMS ARE ONLY A STARTING POINT

1. First, I want to unleash your creative juices, for the greater good.

2. Second, we need to focus on the future for our specific arena -- the tax-oriented counsel.

(a) Are we mentoring and educating the younger members?

(b) Don't we need to do more to communicate our ideas to Congress and the Administration?

3. Third, in an increasing complex global world, we need to simplify.

(a) I have tried to share a vision for true simplification for the entrepreneur, as well as the publicly traded entity.

(b) One way to reach the point where simplification becomes more acceptable is to focus on specific areas for tax reform.

B. GOING FORWARD

As George Santayana said, "Those who cannot remember the past
are condemned to repeat it."

1. Complexity leads to "tax shelters" (in the pejorative sense) and tax abuse.

2. Please take my thoughts and move on to other areas --

(a) Tax accounting -- Why not go back to the cash method, other than installment sales, for the entrepreneur? (See H.R. 4643, introduced on April 25, 2012, to expand the availability of the cash method of accounting for small businesses.)

(b) Global -- Territorial vs. credits (as in the state income tax world)

3. Do we ultimately get to a two-tier tax system for business -- one for publicly traded and electing double tax entities, and one for all others?