

University of Mississippi

eGrove

Association Sections, Divisions, Boards, Teams

American Institute of Certified Public Accountants (AICPA) Historical Collection

1992

Blueprint for tax simplification

American Institute of Certified Public Accountants. Tax Division

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_assoc



Part of the [Accounting Commons](#), and the [Taxation Commons](#)

Recommended Citation

American Institute of Certified Public Accountants. Tax Division, "Blueprint for tax simplification" (1992). *Association Sections, Divisions, Boards, Teams*. 434.
https://egrove.olemiss.edu/aicpa_assoc/434

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Association Sections, Divisions, Boards, Teams by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

Blueprint for Tax Simplification

Tax Division

APRIL 1992

AICPA

American Institute of Certified Public Accountants

1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1081

Blueprint for Tax Simplification

Tax Division

APRIL 1992

AICPA

American Institute of Certified Public Accountants

1455 Pennsylvania Avenue, N.W., Washington, D.C. 20004-1081

NOTICE TO READERS

The Blueprint for Tax Simplification is intended to continue the dialogue on the need to simplify the tax law. The AICPA welcomes comments on the concepts and approaches contained in this document.

ACKNOWLEDGEMENTS

The AICPA Tax Division acknowledges the efforts of the Tax Simplification Committee and, in particular, the Blueprint for Tax Simplification Working Group in preparing this report.

Blueprint for Tax Simplification Working Group

Robert M. Brown, Chairman
Betty R. Jackson
Janice M. Johnson
Melbert E. Schwarz
Karin M. Skadden

Tax Simplification Committee

Robert M. Brown, Chairman
Roger J. Conlon
Robert A. Dakin
Paul Farber
Arthur I. Gordon
Hugh S. Hatcher
Bernard W. Nebenzahl
Jeffrey A. Porter
Donald Rocen
Roy Soll
Paul J. Streer
Don J. Summa
Judyth A. Swingen
Ralph C. Youngberg

Tax Executive Committee

Leonard Podolin, Chairman
Harvey L. Coustan, Vice Chairman
Victor E. Barton
Ellen J. Feaver
Robert L. Jones
J. Fred Kubik
Al Kushinsky
Thomas P. Ochsenschlager
Jack S. Oppenheimer
Gerald W. Padwe
Lawrence F. Portnoy
Thomas E. Reardon
Wilburn C. Robinson
Paul A. Schecter
Deborah Walker
Donald H. Skadden, Vice President - Tax

We give recognition to and acknowledge the efforts of Carol B. Ferguson, AICPA Technical Manager, Tax Division. In addition, we give recognition to Bernard A. Finkelstein for his contribution to earlier works in the area of tax simplification.

Copyright © 1992 by the
American Institute of Certified Public Accountants, Inc.
1211 Avenue of the Americas, New York, NY 10036-8775
1 2 3 4 5 6 7 8 9 0 FT 9 9 8 7 6 5 4 3 2

TABLE OF CONTENTS

EXECUTIVE SUMMARY	1
I. THE PROBLEM	3
II. NEED FOR A CONSTITUENCY	4
III. GUIDING PRINCIPLES FOR SIMPLIFICATION	4
IV. FACTORS THAT AFFECT COMPLEXITY	5
General Factors	
1. Complexity Due to the Effects of Change	5
2. Complexity Caused by Subjectivity	6
3. Lack of Consistent Concepts	7
4. Structural Complexity	8
5. Effect on Taxpayers Not Targeted by a Particular Provision	9
Specific Factors	
6. Communication Complexity	9
7. Computational Complexity	10
8. Complexity of Forms	12
9. Administrative Complexity	13
External Factors That Affect the Tax System	
10. Legal Complexity	14
11. Transactional Complexity and Business Dynamics	14
12. Diffusion of Responsibility	14
13. Inconsistent Application of Rules	14
14. The Legislative Process	14
V. DEVELOPING MEASUREMENT INSTRUMENTS	15
VI. USING THE SIMPLIFICATION MEASUREMENT TOOLS	16

EXECUTIVE SUMMARY

The Problem

The complexity of the United States tax law has reached the point where many taxpayers and practitioners believe that it is undermining the system of voluntary compliance. Frequent change, the lack of deliberation in the legislative process, and the increasing magnitude and complexity of the Internal Revenue Code are the principal causes of concern. The following significant problems result from the existing tax complexity:

- Erosion of voluntary compliance. Taxpayers and tax practitioners find it harder to understand and comply with the tax law.
- Perceptions of unfairness. The tax law is perceived by many as unfair.
- Difficulty of administration. It is difficult for the Internal Revenue Service to administer the tax law.
- Compliance costs. The cost of compliance for all taxpayers is increased. Of particular concern are the many taxpayers, especially those with unsophisticated financial affairs, who are forced to seek professional tax return-preparation assistance.
- Interference with economic transactions. Complexity interferes with economic decision making.

To maintain a viable voluntary tax system, simplification must have a prominent position in the tax process, although it should not take precedence over revenue and tax policy objectives. While a tax system that is simple for all taxpayers may never be designed, simplification must be an integral part of the tax legislative, regulatory, and administrative process. A tax system that is simple for some and significantly simpler for all is achievable.

What is Needed

At least four elements are necessary to achieve a simpler tax system, both through new legislative proposals and a review of existing tax law:

- A visible constituency must exist to communicate the need for simplification to Congress and the Administration.
- Guiding principles for tax simplification must be identified.
- Factors that contribute to complexity must be identified. This will lead to development of a framework for analyzing the balance among equity, policy, revenue, and simplification objectives.

- Simplification must be considered at all stages of the legislative process. The legislative process must provide adequate time for thorough consideration of tax proposals, including simplification aspects.

Guiding Principles and Factors that Result in Complexity

This document identifies guiding principles that should be considered in pursuing a simpler tax law as follows:

- The legislative process should consider the objectives of equity, efficiency and revenue and balance them with the objective of simplification.
- Once tax policy objectives have been identified, alternative approaches to implementing policy should be considered to achieve the simplest possible design and administration.
- The long-term benefit of any change made to simplify the tax law should more than offset any complexity that results by a change.
- The law and regulations should be drafted within a rational, consistent framework.
- There should be a balance between simple general rules and more complex detailed rules.
- The benefit of a provision should be balanced against the cost of complying with the provision.
- Tax rules should build on existing business practices and common industry record keeping.

Also identified in this document are factors that result in complexity: Complexity Due to the Effects of Change; Complexity Caused by Subjectivity; Lack of Consistent Concepts; Structural Complexity; Effect on Taxpayers Not Targeted by a Particular Provision; Communication Complexity; Computational Complexity; Complexity of Forms; Administrative Complexity; Legal Complexity; Transactional Complexity and Business Dynamics; Diffusion of Responsibility; Inconsistent Application of Rules; and, The Legislative Process.

One approach to evaluating these factors is the use of Indicators for Tax Simplification that follow each section. Instruments to aid in evaluating a proposal's contribution to simplification or complexity are necessary to provide a framework for considering tax legislative proposals. It is not sufficient to develop tools for measuring a proposal's effect on the complexity of the law. Procedures should be put in place to ensure that the tools be used and that the information obtained be formally considered in the process.

BLUEPRINT FOR TAX SIMPLIFICATION

I. THE PROBLEM

Tax legislation of increasing magnitude and complexity is being passed by the U.S. Congress virtually every year. The Internal Revenue Code (IRC, or the Code) now contains many extraordinarily complex provisions. The Treasury regulations interpreting those provisions likewise have become increasingly complex. The frequency and scope of legislation make it very difficult for the Treasury Department to issue timely and adequate guidance. As time passes, taxpayers, their advisers, and the Internal Revenue Service (IRS) face increasing uncertainty as to the correct tax treatment of an item.

The cornerstone of tax administration in the United States is a voluntary tax compliance system. Voluntary compliance depends on both the ability and the willingness of taxpayers to comply. Further, it depends on the ability of tax practitioners to understand and properly advise taxpayers. Complexity threatens to erode this system because full compliance increasingly requires an unreasonable outlay of effort and resources. Some taxpayers believe the IRS is incapable of discovering noncompliance. A few have the impression that understanding the tax laws will only serve to increase the amount of taxes they must pay. As a result, there is growing resistance by taxpayers to take the steps necessary to fully comply. Furthermore, complexity adds to the perception of unfairness. Taxpayers who do not understand the tax rules that apply to them often think they are being dealt with unfairly and that some taxpayers have benefits not available to others.

Complexity interferes with business decisions by making the after-tax economics of transactions less certain. Furthermore, some observers express concern that the compliance burden borne by taxpayers and the IRS diverts resources from more productive endeavors. It is conservatively estimated that the aggregate cost of the tax system (including compliance and administration) approximates 5 to 10 percent of tax revenues.¹ It is further estimated that compliance costs from 1982 to 1989 showed a 25 percent increase in time spent on tax matters and a real increase in expenditures by taxpayers on tax matters of approximately 80 percent.²

A tax system that is simple for all taxpayers may never be designed, but a simpler tax system is a critical and achievable goal. The problem of an overly complex tax system has arisen in part because of the dominance of other legislative goals, such as revenue enhancement, rate reduction, and economic and social policy. By working within the constraints imposed by the need to balance the various objectives of the tax system, it will be possible to design a simpler tax system.

To achieve the goal of a simpler tax system, the following steps must be taken to systematically address the problem of complexity in the tax system. First, a visible constituency must emerge to communicate the need for simplification to Congress and the Treasury Department. This step is discussed in section II. Second, principles to guide the design of a simpler tax system must be established. Section III discusses these principles.

Third, the major factors that contribute to complexity must be identified. This can promote the development of a simpler tax law by revealing opportunities for simplification and by providing a framework for a cost-benefit analysis that considers revenue, equity, and policy objectives as well as simplification. Section IV identifies these factors. One approach to evaluating these factors, use of the Indicators for Tax Simplification, is included in this document. Finally, consideration of the simplification aspects of a proposal must occur at all stages of the legislative process. Changes must be made in the process to provide adequate time for a thorough consideration of tax proposals, including simplification options. Section V outlines the need to develop instruments for measuring complexity and the appropriate procedures, while Section VI contains methods designed to ensure that these instruments are used and that the results are evaluated and subjected to review.

II. NEED FOR A CONSTITUENCY

The constituency for simplification is often silent in the legislative and administrative process. Some members of Congress and tax professionals have begun to actively support simplification initiatives. However, the development of a stronger voice for simplification is necessary if simplification is to become an integral part of legislative and regulatory decision making. The natural constituents for tax simplification are taxpayers, tax practitioners, and tax administrators.

To achieve a simpler tax system, there must be organized demand from all interested parties. The degree of complexity of the tax system indicates that the demand for tax simplification has been insufficient. A successful simplification initiative must be driven by committed leadership that continues to demonstrate the benefits of simplifying the tax law and maintains the priority of those benefits in any legislative initiative.

Simplification yields a number of benefits. Economic resources will become available for more productive endeavors. Taxpayers will be more willing and able to comply when they can understand their tax responsibilities. Further, taxpayers' confusion, frustration, and the psychological burden of dealing with their responsibilities will be reduced.

III. GUIDING PRINCIPLES FOR SIMPLIFICATION

In pursuing a simpler tax law, the following guiding principles should be considered:

- The legislative process should consider the objectives of equity, efficiency, and revenue and balance them with the objective of simplification. Simplification should not take precedence over other objectives, but it should be given a prominent position.
- Once tax policy objectives have been identified, alternative approaches to implementing policy should be considered to achieve the simplest possible design and administration. This process of considering alternatives should occur at all stages of the legislative and regulatory process.

- The long-term benefit of any change made to simplify the tax law should more than offset any complexity that results by a change. Change in and of itself increases complexity because taxpayers must learn and comply with new rules.
- The law and regulations should be drafted within a rational, consistent framework. For example, this can be accomplished through uniform treatment of different types of taxpayers, building on existing concepts, clear and consistent definitions, and horizontal drafting.³ Further, legislation should be drafted beginning with the general rule and narrowing down to the specific rules.
- There should be a balance between simple general rules and more complex detailed rules. For example, the hobby loss rules provide sufficient objective standards to ease compliance, but too many objective standards in the interest tracing rules result in significant complexity.
- The benefit of a provision should be balanced against the cost of complying with the provision. For example, the benefit of eliminating a perceived abuse must outweigh the compliance costs incurred by affected taxpayers. Further, in measuring the level of complexity, the characteristics of the group of taxpayers targeted must be taken into account (e.g., the earned income credit is extremely difficult for affected low-income taxpayers to compute). Finally, provisions targeted at one group of taxpayers often create unintended consequences for others (e.g., provisions aimed at highly complex taxpayer situations often must be taken into account by the average taxpayer).
- Tax rules should build on existing business practices and common industry record keeping. Throughout the Code, computational complexity exists where different calculations of the same item are required for different purposes (e.g., depreciation calculations).

IV. FACTORS THAT AFFECT COMPLEXITY

An important step in simplifying the tax system is identification of the factors that create complexity. A list and brief description of those factors follow. The factors fall into three categories: general factors; specific factors; and, external factors that affect the tax system.

GENERAL FACTORS

1. Complexity Due to the Effects of Change

Change in itself creates complexity for all affected parties. This is true whether the change results from an attempt to simplify existing provisions or from the addition of new tax concepts. Change causes complexity because there is necessarily a learning curve in mastering new rules. Transition rules are of a particular concern because the rules that must be learned are, by definition, temporary. The instability caused by frequent changes in the

tax law in fact makes the law more complex, because affected parties must learn and apply different rules for different tax periods. Furthermore, the instability increases the perception of complexity for many taxpayers. It must be recognized that continued change within an area of the law creates complexity even where isolated provisions are not complex. Depreciation provisions are a good example.

This is not intended to suggest that policy considerations calling for change should never be allowed to override complexity concerns. Tax policy must continue to be an important element in any decision. Nor does it imply that change cannot, on balance, make a contribution to simplification or that transition rules are never justified. A change may ultimately result in less complexity because it eliminates difficult, unworkable, or complex rules; equity may demand that taxpayers have access to favorable transition rules despite the attendant complexity. The concern is that the goal of simplification requires that the long-term benefits of a change in the law be weighed against the complexity created by the change.

Effective dates for change also have an impact on complexity. Prospective provisions give taxpayers time to learn about the change and adapt to it. In cases where there are multiple changes, using the same effective date for all changes simplifies their implementation. Last-minute tax law changes provide insufficient time for tax administrators, tax practitioners, and taxpayers to fully understand and implement the new rules.

Indicators for Tax Simplification

- o Are the changes extensive?
- o Can the desired result be achieved in a less complex way?
- o Have other changes been made in this area recently? Have there been other significant recent changes in the Code?
- o Has the complexity of the change been evaluated based on the costs of compliance and administration? Have those costs been weighed against the long-term perceived benefits of the change?
- o Are transition rules necessary? If so, are they too complex? Have the proposed rules been balanced against the complexity they create?
- o Do the proposed effective date or dates result in too much complexity?

2. Complexity Caused by Subjectivity

To the extent that a provision is objective, or is determined by means of an objective test, it will be less complex. Despite the appeal of this general proposition, some provisions or concepts are inherently subjective in nature and not readily amenable to quantification in an objective test. Examples are *trade or business* and *ordinary and necessary*. The conditions necessary to satisfy the criteria for these concepts have become more predictable over time because of extensive administrative and judicial interpretation. However, this predictability only holds for those with significant training and experience in tax law.

Other subjective provisions are so dependent on facts and circumstances that even extensive interpretation and litigation have not been sufficient to yield a high degree of certainty in the law. An example would be the requirement that compensation be "reasonable" to be deductible. Significant time and effort continue to be spent by experienced practitioners on planning to avoid the adverse consequences of "excessive" compensation.

Some attempts to lend more certainty to the law by introducing objective standards to clarify a subjective term have increased complexity. For example, *substantial economic effect* and *material participation* are defined largely by numerous examples, and interest deductibility must be determined by wading through pages of rules. Too much detail can result in tax traps.

Thus, while introducing some objective standards can further simplification, an overload of objectivity creates its own form of complexity.

Indicators for Tax Simplification

- Does the provision incorporate objective tests that serve to reduce or eliminate uncertainty?
- Do the objective tests result in substantial additional complexity?
- Is the complexity a result of the introduction of objective standards necessary to fulfill the intent of the law?
- Does the provision make use of a subjective concept that is already so well established or clear that few would have difficulty applying it?
- Is it possible to use or modify an existing concept rather than introduce an entirely new one?

3. Lack of Consistent Concepts

To the extent that tax provisions are arbitrary and not consistent with traditional economic, accounting, or tax theories, they become much more complex because they cannot be derived logically and therefore must be memorized. For example, consolidated return principles have been abandoned in the recent loss disallowance rules.

Consistency should be a goal of our tax system. Tax principles and consistent concepts have become vulnerable due to continual legislative changes, perceived abuses, and budget pressures. Many limitations enacted to prevent abuse add further complexity and diverge from basic tax principles. Provisions that require new record keeping systems (such as the alternative minimum tax [AMT] depreciation, AMT adjusted current earnings, and uniform capitalization of inventory costs) contribute to complexity. Any time a new concept is introduced, it should be tested against the basic tenets of the tax system.

Indicators for Tax Simplification

- Is the provision contrary to industry standards or normal business practices?
- Does the provision create significant record keeping burdens for the taxpayer in addition to the regular financial books and records?
- Is the provision inconsistent with other provisions of the Code, other regulations, or other rulings?

4. Structural Complexity

The structure of the tax law creates complexity beyond that associated with specific Code provisions. The different treatment accorded capital gains and losses and ordinary income and losses is one example of structural complexity. Interactions between various Code sections and the use of cross-referencing also create substantial complexity. For example, the owner of "listed property" must first understand the rules for cost recovery in IRC section 168 and then recognize the impact of the section 280F provisions on cost recovery calculations. The asset-by-asset approach taken in the accelerated cost recovery systems requires recapture calculations under various sections of the Code that would not be required if an open-ended account system were enacted.

The introduction and codification of new concepts add to structural complexity. For example, the alternative minimum tax (AMT) introduces many new concepts and produces a great deal of interaction with existing regular tax provisions. The AMT significantly increases the number of taxpayer choices and makes the selection of appropriate planning and compliance strategies much more difficult. In other instances, new meanings are assigned to familiar, long-used terms. For example, the word *passive* retains its historical general meaning of unearned but now is also used in a much more technical sense in section 469. Lack of statutory definitions of phrases, such as, *trade or business* and *earnings and profits*, and the accompanying reliance on regulations and case law, permit flexibility but also increase complexity. Multiple sets of rules in the Code (e.g., those governing attribution of ownership) suggest that horizontal drafting should be employed as frequently as possible.

Indicators for Tax Simplification

- Does the provision apply differently to different types of taxpayers? For example, are individuals treated differently from corporations? Are individuals from various income levels treated differently?
- Does the provision build on existing principles in the Code or must new concepts be introduced or new meanings be applied to terms hitherto used in other ways?
- Does the provision create different categories of income and/or deductions that are essentially new tax systems?
- Does the provision interact with other provisions of the Code in such a way that the decisions facing taxpayers are increased?

5. Effect on Taxpayers Not Targeted by a Particular Provision

Provisions targeted primarily at taxpayers with complex tax situations, who are often better able to afford extensive tax advice and return preparation, often create substantial and unintended problems for less sophisticated taxpayers. There may be situations in which a burden has to be placed on many taxpayers in order to provide reasonable treatment for the targeted taxpayers. The use of thresholds and safe harbors can alleviate this problem, but sometimes it can create others.

Since ignorance of the law has never been considered an acceptable reason not to comply, knowledge is required of all taxpayers, whether or not they are affected by a particular provision. Thus, while a safe harbor may in the end exempt a taxpayer, it is the taxpayer who incurs the additional compliance burden of determining whether or not a particular provision applies and whether a safe harbor can be invoked. Furthermore, a sense of unfairness results from the "cliff effect" of a threshold or safe harbor, by which a taxpayer just misses qualifying. Phasing the rules in and out increases the perception of fairness but adds complexity to the calculations required.

A taxpayer may learn the law, keep the necessary records, and perform the required calculations, only to find that the threshold exceeds the amounts he or she has calculated, as in the case of miscellaneous itemized or medical deductions. Another taxpayer may fail to keep records and forgo deductions because of the perceived compliance burden.

On the other hand, many less sophisticated taxpayers must keep track of depreciation and basis for AMT purposes, even though they may never actually find themselves subject to the alternative minimum tax. In instances such as this, income thresholds would help reduce the record keeping burden.

Indicators for Tax Simplification

- Does the provision affect only the target group?
- Are dollar thresholds and safe harbors provided to exempt some taxpayers from the rule?
- Is there a cliff effect that will have an impact on the taxpayer's sense of fairness?
- Are basic rules set forth that allow taxpayers not affected by the provision to easily determine that fact?
- Is the degree of complexity appropriate to the level of sophistication of the taxpayers most likely to be affected?

SPECIFIC FACTORS

6. Communication Complexity

The Code is replete with terms of art. In many cases, a term of art (e.g., *related party*) is defined differently for different purposes. The structure of the Code itself, and cross-references between Code sections, make interpretation difficult.

Throughout the Code, terms are used that are not clearly defined for all contexts or that may have more than one meaning. For example, the term *related taxpayer* has one meaning in section 267 and another in the mitigation provisions of section 1313. Differences between concepts such as *controlled groups* and *affiliated groups* are also hard to grasp. Definitions of the same or similar words also differ among the various types of taxes.

It is difficult to apply a relatively straightforward term such as *earned income* in light of the increasing complexity of our tax structure. Furthermore, a long-established term such as *adjusted gross income* becomes more confusing when, in certain situations, *modified adjusted gross income* must be computed (e.g., when a taxpayer has rental real estate activities, computes individual estimated tax payments, or may be subject to tax on social security benefits).

The cross-referencing from one Code section to another is also difficult at times. For instance, in computing the allowable exclusion for employer-provided child-care assistance under section 129(b)(2), the special limitation on income for a student spouse contained in section 21(d)(2) is often overlooked by the tax planner, who simply sees a \$5,000 limit in the body of section 129. Some of the complexity associated with cross-references could be eliminated if the Code consistently included a brief description of the interacting provision, as well as the Code section reference.

Indicators for Tax Simplification

- o Are the terms used clearly defined?
- o Are the terms used subject to different definitions elsewhere in the Code?
- o Is the section self-contained or does it require substantial cross-referencing and/or knowledge of other areas of the Code?
- o Are the terms used in the section easily understood in light of existing tax law?

7. Computational Complexity

The determination of taxable income and net tax liability is essentially a mathematical process. Therefore, any self-assessment system, no matter how simple, requires taxpayers to make calculations. In the last decade, the number of necessary tax calculations has increased steadily. For many taxpayers, these computations are now excessively complex and often redundant.

With each new tax law, the IRS has to add lines to old forms, design new forms, and insert additional worksheets into the instructions to assist taxpayers in making mandated computations. Businesses have to develop and maintain extensive data bases to comply with new rules (e.g., for inventories, depreciable assets, and pensions).

Computational complexity is generally introduced into the law with the intention of enhancing equity. Congress enacted the earned income credit to benefit the working poor. Although this provision applies to only a small segment of the population, it is historically

the most error-prone line item on individual tax returns. The target population unfortunately has difficulty making the required computations.

As income levels rise the tax benefits of various deductions and credits are removed, again in the name of equity. Deduction and credit limits or phaseouts, as well as the numerous recalculations required by the alternative minimum tax, definitely increase computational complexity. They also increase the probability that calculations will be incorrect or overlooked.

In certain instances, the Code allows optional methods of calculation that, in theory, are simpler. Their presence merely injects another layer of computational complexity. Taxpayers will perform both the regular and optional calculations to determine the most advantageous method of reporting. The allowance of optional calculations should be the exception to the rule.

Advances in technology mitigate some of the impact of computational complexity. Computers now maintain the multitude of depreciation schedules required for tax purposes. They also perform the calculations mandated by the uniform capitalization of inventory costs and adjusted current earnings rules. Lawmakers seem to have made the tacit assumption that they can add redundant sets of calculations which, because computers can handle them, will not increase complexity. Unfortunately, computers, software, and competent computer staff are expensive resources that most individuals and many businesses cannot afford. In addition, new software or hardware must be added whenever the tax law changes.

This again raises the fundamental cost-benefit issue. Can income not be measured and the tax liability assessed in an equitable manner without so many costly and confusing computations?

Indicators for Tax Simplification

- Are the calculations understandable to the target population? Are they excessively error-prone?
- Are multiple calculations required for essentially the same items?
- Are the numbers derived from complex calculations, such as the uniform capitalization of inventory cost rules, significantly different from amounts determined under simpler and already existing systems? Could the policy or revenue objective be roughly achieved by replacing complex calculations with percentage adjustments?
- Are compliance and administrative costs increased by requiring these calculations?
- Are the costs of compliance justified when weighed against the revenue either raised or protected?

8. Complexity of Forms

Compliance behavior is a direct function of taxpayers' ability to understand their obligations and to correctly report tax-relevant transactions. Therefore, tax forms, instructions, and publications are a critical link between the tax laws and compliance by taxpayers. These materials themselves affect the complexity faced by taxpayers. They also have a direct impact on effective administration by the IRS. Legislative sensitivity to the manner in which tax law provisions must be implemented is the foundation of effective communication of compliance responsibilities to taxpayers.

In structuring tax forms, the IRS must strive for the most user-friendly products. The tax forms should use familiar words and terminology, limit the request for information necessary for other than accurate reporting, and be well organized and easy to read.

The ability to reduce complexity in these materials is constrained because the forms must implement statutory requirements. For example, the form implementing the 1986 Tax Reform Act treatment of home mortgage interest had to incorporate calculations of deductible interest on acquisition indebtedness as well as on home equity loans for medical and educational expenditures. In addition, the form had to accommodate special calculations for grandfathered debt and the cost-basis ceiling for new acquisition indebtedness. Congress subsequently simplified the limitation on the deductibility of home mortgage interest, removing the need for a separate form altogether. This revision would not have been necessary had Congress appreciated the reporting difficulties involved in its initial proposal.

In 1991, the IRS had considerable difficulty with developing forms and instructions for calculating the earned income credit as amended by the Revenue Reconciliation Act of 1990. The required computations are very difficult and involve alternative calculations. This was a particularly perplexing problem because the affected taxpayers are those with the lowest income, the group least able to comply, because of lack of education and resources to pay for professional assistance.

Indicators for Tax Simplification

- Can the reporting requirements be presented in the forms and instructions in an effective and understandable manner to the targeted taxpayers?
- Can the reporting requirements be contained on one form or are multiple forms and/or worksheets necessary?
- Will the required reporting involve record retention beyond what is normally applicable?
- Can tax form instructions be drafted that provide meaningful guidance without using statutory language and terms of art?

9. Administrative Complexity

New legislation places new demands on the administrative resources of the IRS and Treasury Department. The most immediate impact is felt in the task of redesigning tax forms and instructions to incorporate the changes. Interpretation of the law through regulations and rulings is necessary and may require revision of the recently issued forms. It may be difficult or impossible to issue timely guidance before effective dates. IRS personnel must become acquainted with new law promptly to provide guidance to taxpayers seeking to comply. Often they must be fully conversant with several conflicting provisions governing the same area (e.g., interest deductibility rules before 1987 and tracing rules after 1986) in order to perform the audit function.

Taxpayers and the IRS alike have difficulty interpreting complex provisions. In addition, the IRS faces an even greater burden than taxpayers when factual issues are involved because taxpayers are in control of the reporting and presentation of facts relevant to a particular issue. For example, enforcing the research and experimentation credit is an extremely difficult task for the IRS because of problems in tracing and categorizing various expenditures and in judging whether the taxpayer meets requirements such as "technological innovation." Likewise, enforcing the new luxury excise tax rules is difficult because of problems in identifying taxable transactions.

Complexity in making factual determinations is dramatically reduced from an administrative perspective to the extent that a provision relies on the interaction of two parties with contrary or adverse interests. For example, contracts for the sale of assets or an entire business are the result of pressure to establish the true purchase price; each party has tax and non-tax incentives to correctly state the agreed-upon price in the contract and purchase price allocation. These conflicting interests do not afford perfect controls, but they aid in verification.

Indicators for Tax Simplification

- Will the change require drafting or revising regulations, rulings, forms, etc.?
- Is there sufficient time for regulations and rules to be developed, issued, and understood before the effective date? If not, are there safe harbors on which taxpayers may rely in the interim?
- Could the goal of the proposal be accomplished in some other way that would not impose as high an administrative burden?
- Does the IRS have adequate resources (staff and technology) to implement the change and/or monitor compliance?
- Can third-party reporting be used to enhance compliance? Would the cost of this reporting justify the revenue raised or protected?

EXTERNAL FACTORS THAT AFFECT THE TAX SYSTEM

10. Legal Complexity

The legal environment creates certain complexities outside the control of the tax system. For example, the law regarding partnerships affects the allocation of partnership debt to individual partners, community property laws necessitate rate schedule changes to achieve parity among the states, and legal rights of ownership affect the transfer tax statutes.

11. Transactional Complexity and Business Dynamics

Some transactions are inherently complex. In many cases, the complexity of the transaction will necessitate complexity in the governing statute and regulations. Similarly, technological changes in the communication of business transactions in the global marketplace, as well as the proliferation of new financial instruments and transactions, result in additional complexity as new laws, rules, and regulations are promulgated to cope with the changes.

12. Diffusion of Responsibility

Because responsibility for the problems and costs of complexity is not specifically assigned within Congressional staffs, the Treasury Department, or the IRS, there is no accountability for these effects. Thus, there is no strong incentive for anyone involved in the legislative or administrative process to tackle the problem as a priority. A focused responsibility for simplification should be mandated.

13. Inconsistent Application of Rules

The multiple jurisdictions and levels of the courts lead to uncertainty because of different applications and interpretations of rules. The fact that state and local tax rules may dramatically differ from the federal rules increases complexity exponentially.

14. The Legislative Process

Complexity often is compounded by imperfections in the legislative process that make adequate deliberation impossible. The process must allow sufficient time to evaluate how well a proposal meets the goal of simplification in conjunction with its other merits. Full public hearings and debate on changes or new provisions provide an opportunity for Congress to learn of the potential administrative, compliance, and policy concerns of taxpayers. With public exposure, Congress has a better opportunity to craft legislation that will stand the test of time and not need frequent amendment to address technical problems. Hearings also give the public a better understanding of the provision and its purpose, and they increase the overall perception of fairness in the tax system.

While the judiciary is the focal point for settling controversies between the IRS and taxpayers, Congress plays an important role as well. In cases where factual differences preclude establishing broad principles and rules, Congress must consider the efficacy of establishing objective rules to eliminate the controversies. A current example is the debate on the amortization of intangibles. While establishing fixed amortization lives will create inequities in individual situations, the resulting certainty will make the law much easier to comply with and administer. These two competing consequences have to be weighed in making the final decision.

Indicators for Tax Simplification

- Have the changes under consideration been subject to public hearings and debate?
- Is the change necessary to resolve a costly ambiguity in the law? Is that simplification justified in light of the inequities created by the change?
- Can the same result be accomplished in a less complex way?

V. DEVELOPING MEASUREMENT INSTRUMENTS

Instruments that aid in evaluating a proposal's contribution to simplification or complexity are necessary to provide a framework for considering tax legislative proposals. Such instruments should provide:

- A rational method for analyzing the proposal's contribution to simplicity or complexity.
- A method that allows for comparability between competing alternatives.
- Objectivity and replicability.
- A means of highlighting areas where improvement is necessary.

One example of an instrument designed to accomplish these objectives is the Indicators for Tax Simplification. The indicators consist of factors and considerations indicative of both positive and negative influences on the complexity of the tax system. The ability of a proposal to have as many positive influences as possible and to avoid having as many negative influences as possible should indicate that it will contribute to the simplification of the tax system.

Many proposals needlessly add to the complexity of the tax system solely because their potential effects in this regard were not considered. Use of the indicators encourages such an evaluation to occur. Over time, it will become an integral part of the legislative process. It is expected that use of the indicators will identify areas in which the contribution to simplification of any proposal can be enhanced.

The indicators, or a similar framework for the disciplined examination of a proposal's effects on simplification, should be used whenever a proposal is being considered for legislative or regulatory action.

To compare various competing proposals, it may be desirable to weigh the factors included in the indicators for their relative contributions to simplification in the context of any specific proposal. This will allow for the development of a simplification or complexity scale that can be used to rank competing proposals.

Whether or not a complexity scale is used to evaluate competing proposals, the analysis of a proposal's effect on each factor included in the indicators can still be useful. The indicators will demonstrate whether the proposal is assessed negatively for a particular factor. This information will focus attention on possible changes that would minimize the increase in complexity. Where the proposal's effect on a factor is positive, consideration should be given to whether the maximum level of simplification has been attained given the need to meet other objectives.

The Indicators for Tax Simplification is an example of a tool that addresses only a proposal's contribution to simplification. It may also be desirable to develop tools that will balance simplification with other demands placed upon tax law, such as fairness and the need to raise revenue. Such tools will be useful in determining which simplification proposals are most compatible with other objectives of our tax law.

VI. USING THE SIMPLIFICATION MEASUREMENT TOOLS

It is not sufficient to develop tools that measure a proposal's effect on the complexity of the law. Procedures must also be put in place to ensure that the tools will be used and that the information obtained will be formally considered. The following procedures are suggested as a means of ensuring consideration of a proposal's impact on tax law complexity.

Hearings Process Procedures - Hearings on tax proposals before either the House Ways and Means or the Senate Finance Committee should require disclosure of their effect on simplification. Analysis of simplification effects by the staffs of both the Joint Committee on Taxation and the Tax Legislative Counsel should be published and discussed. The staff of the Joint Committee on Taxation should be required to adopt a methodology for evaluating the simplification aspects of a proposal and to discuss the results in any hearing pamphlets (or other documents) published. In addition, simplification options with respect to the proposals under consideration at the hearing should be discussed.

Testimony by representatives of the Treasury Department should include an independent analysis of the effect of any proposals on simplification, as well as evaluation of the published comments of the staff of the Joint Committee on Taxation.

Legislative Markup Process - All proposals considered during the legislative markup process should also be evaluated to determine their effect on simplification. If the markup begins with the acceptance of a Chairman's Mark or other basic document, a simplification analysis should be required for each item in the mark. Amendments must include analyses of their effect on simplification before being considered. At each step, the staff should be prepared to offer alternatives to the items included in the mark or offered as amendments that could make greater contributions to simplification.

Legislative Drafting Process - The staffs of the House and Senate Legislative Counsel's Offices should be instructed by the members to undertake a study of drafting techniques that would contribute to simplification, such as horizontal drafting. Candidates for horizontal drafting include the constructive ownership rules and the provisions governing pass-through entities and their owners or beneficiaries. The respective Legislative Counsel's Offices should be required to publish the results of their study within a reasonable period of time.

Regulatory Process - The IRS should be required to include an analysis of the effect of any proposed, temporary, or final regulations on simplification, along with a discussion of alternative approaches.

Simplification Initiatives - Appropriate governmental staff (Treasury, IRS, Ways and Means, Finance, Legislative Counsel, and/or Joint Committee on Taxation) should be required periodically to publish simplification initiatives that could form the basis of future legislation. Such initiatives could include:

- A review of the Internal Revenue Code for "deadwood" provisions as well as of the Code and of regulations for complex rules that should be withdrawn or substantially simplified.
- Analyses of various rules to determine where horizontal consistency is lacking (proposals to enhance horizontal consistency would be expected); development of a tax term glossary to ensure consistent use of terms across different sections of the Code.
- Analyses of specific areas of the Code to determine the level of complexity present and to make proposals for the reduction of complexity.
- Creation of a simplification director or czar, an official whose sole duty would be to review tax legislation and regulations for their effect on simplification, and publish those findings and offer alternatives. If established, such an office should be nonpartisan in nature.

ENDNOTES

1. Slemrod, Joel and Nikki Sorum, "The Compliance Cost of the U.S. Individual Tax System," National Tax Journal, December 1984. Also see Arthur D. Little, Development of Methodology for Estimating the Taxpayer Paperwork Burden, Final Report of the Department of the Treasury, Internal Revenue Service, Washington, DC, June 1988. Also see Blumenthal, Marsha and Joel Slemrod, "The Compliance Costs of the U.S. Individual Income Tax System: A Second Look After Tax Reform," Office of Tax Policy, University of Michigan, 1991.
2. See Blumenthal and Slemrod (1991).
3. Horizontal drafting occurs where a rule placed in a single Code section will apply in other Code sections.

