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Proceedings of the Invitational Conference on Reduction of Income Tax Complexity

Silva A. Madeo

American Institute of Certified Public Accountants. Tax Division

American Bar Association. Section of Taxation

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PROCEEDINGS OF THE INVITATIONAL CONFERENCE ON REDUCTION OF INCOME TAX COMPLEXITY

A Joint Project of the
American Institute of Certified Public Accountants Tax Division
and the American Bar Association Section of Taxation

Proceedings of the Invitational Conference on Reduction of Income Tax Complexity

AICPA/ABA

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A Joint Project of the
American Institute of Certified Public Accountants Tax Division
and the American Bar Association Section of Taxation

The 1990 Invitational Conference on Reduction of Income Tax Complexity, which is the subject of this report, was held January 11-12, 1990 in Washington, D.C. The conference was jointly cosponsored by the American Institute of Certified Public Accountants Tax Division and the American Bar Association Section of Taxation.

Professor Silvia A. Madeo
of the University of Missouri - St. Louis
Proceedings Editor

The views and conclusions expressed herein are those of the authors and not necessarily those of the American Institute of Certified Public Accountants, the American Bar Association, or of the conference organizers.

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Invitational Conference on Reduction of
Income Tax Complexity

FOREWARD

The federal income tax system has become increasingly more complicated and less understandable in the past several years. This is the view of the taxpaying public as well as the view of most practitioners, government officials, and academics. Both the perception and the reality of this condition have caused many--including administrators of the tax system--to question whether the tax system continues to be administrable.

Many factors have led to this state of affairs. They include the following often stated concerns:

(a) frequent (annual and sometimes more frequent) amendment of the Internal Revenue Code, including redefinition of the term "taxable income";

(b) increasing complexity to cover increasingly complex business situations;

(c) major changes in the legislative process;

(d) the Congressional response to the interplay between government representatives and taxpayer representatives in the formation of tax legislation;

(e) the revenue driven basis of current tax legislation;

(f) the constant choice of "equity" over "simplicity"; and

(g) lengthy and enormously detailed regulations, coupled with long delays in the issuance of both proposed and final regulations.

In response to these factors, the Tax Division of the American Institute of Certified Public Accountants and the Tax Section of the American Bar Association jointly sponsored the Invitational Conference on the Reduction of Income Tax Complexity in Washington, D.C., on January 11 and 12, 1990. Our committee, which was charged with the responsibility for the organization and presentation of that conference, is now pleased to publish this volume containing the papers presented at that conference and a summary of the proceedings.

Since this conference, there have been many encouraging developments and a growing national awareness of the need to reduce the complexity in our federal tax laws. We believe that this conference was a catalyst and that the publication of these excellent papers and proceedings should further advance these efforts.

The committee wishes to thank all who participated. In particular we wish to acknowledge the tireless and effective support given to our efforts by the staff of the AICPA Tax Division under the direction of Carol B. Ferguson. We also wish to thank Professor Silvia Madeo for her efforts as proceedings editor.

We do not expect that the solution to the perceived problems will be easy, nor that there will be immediate change. We do hope that this conference has, however, started a dialogue which will be continued by the publication of these papers and that this will lead to substantial changes over the next few years.

The income tax system is vital to our American form of government. Our concern is that it function well--if not, we fear that serious government deficiencies will result.

Co-Chairmen:
H. Stewart Dunn, Jr.
Don J. Summa

Members:
David G. Glickman
Richard Katcher
Ray M. Sommerfeld
Jay Starkman
Alvin C. Warren, Jr.
Donald C. Wiese

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Part I

Papers Presented

THE BUDGET PROCESS AND TAX SIMPLIFICATION/COMPLICATION

CHARLES E. McLURE, JR.*

It is without doubt the most significant reform in the history of the income tax.--Jeffrey H. Birnbaum and Alan S. Murray, Showdown at Gucci Gulch (1987), commenting on TRA '86.

[T]he increasing complexity and incoherency of the current Internal Revenue Code necessitates tax reform. True tax reform will not be achieved unless there is a significant simplification of code provisions."--David Brockway, former chief of staff of the Joint Committee on Taxation (1986), (speaking in February 1986).

Complexity is the hallmark of this legislation.--Arthur Andersen (1986).

INTRODUCTION

There seems to be little disagreement that the U.S. tax system has become much more complicated in recent years. There is also substantial agreement that this increase in complexity is undesirable. David Bradford has written the following:

> A law that can be understood (if at all) only by a tiny priesthood of lawyers and accountants is naturally subject to popular suspicion. By undermining popular support, complexity undermines the self-assessment on which economical compliance depends. Making taxpayers record and report information that is inherently difficult to audit places an often prohibitive tax on honesty. Furthermore, dealing with the law's arcane provisions requires rare talents that might be better applied to other tasks in the economic system.[1]

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*Charles E. McLure, Jr. is a Senior Fellow at the Hoover Institution at Stanford University. From October 1983 through July 1985 he was Deputy Assistant Secretary of the Treasury for Tax Analysis. As such he had primary responsibility for the development of Tax Reform for Fairness, Simplicity, and Economic Growth, the department's 1984 tax reform proposals to President Reagan that became the basis for the Tax Reform Act of 1986. He wishes to thank David Bradford, Timothy Conlan, Ed Gramlich, Donald Keifer, Paul McDaniel, Ron Pearlman, Catherine Rudder, Allen Schick, Karla Simon, Jay Starkman, Gene Steurele Randall Strahan, Don J. Summa, Victor Thuronyi, James Verdier, John Witte, Al Warren, George Zodrow, and especially David Brockway for their helpful suggestions and comments on previous drafts of the paper. As always, and perhaps more than usual, the views expressed here should be attributed only to the author, although he has freely drawn on the wisdom of these persons and others. (At times, it has been difficult to avoid the temptation to lift large sections of Brockway's comments and incorporate them in the paper!)

This paper examines the extent to which increased complexity can be traced to recent changes in the budget process.

The topic of this paper probably did not exist ten years ago, certainly not twenty years ago.[2] The pronounced interaction between the budget process and the simplification or complication of the tax law seems to be a phenomenon of the 1980s. It has its origins in several developments: the Budget Act of 1974; the end of the days of easy expansion of federal spending on domestic programs and tax expenditures financed by sustained economic growth, by "bracket creep" in the individual income tax, and by the end of the reduction in the relative importance of defense spending; the massive tax cut of 1981 that left a budget deficit of roughly 5 percent of the gross national product (GNP); the subsequent promises of two presidents that we will have no new taxes; the "revenue neutrality" mind-set that has characterized tax policy discussions since at least the Treasury Department's 1984 tax reform proposals to President Reagan; and the budgetary limitations imposed by the Gramm-Rudman-Hollings targets for deficit reduction. These influences, singly and jointly, have inhibited attempts to simplify the income tax, since to do so would lose revenue, and have produced a tendency toward complexity, inequities, economic distortions, and general fiscal craziness. (Examples of fiscal craziness are considered further in the next section.) This is particularly disturbing, given the interest in some quarters in a constitutional amendment that would require budgetary balance.[3] These tendencies are almost certainly aggravated by the "good government" changes in the tax legislative process that have led to a pattern of erratic tax policy over the past dozen years. Reforms that were intended to expose policy-making to the cleansing effect of sunlight also exposed it to the intense scrutiny of lobbyists.

This interaction between budget process and tax policy takes at least four forms. First, an atmosphere in which the tax-writing committees are "under the gun" to meet the revenue targets of reconciliation resolutions is not conducive to deliberate and careful consideration of tax policy alternatives. Even if the Congress begins its deliberations with a menu of proposals that are defensible on policy grounds, at some point the process is likely to become driven by revenue estimates instead of policy considerations. When this happens, proposals are adopted because they raise revenue, not because they make sense. Others may have complicating "bells and whistles" that either save or raise revenue that would not be found in the absence of a revenue constraint. Similarly, budgetary constraints may prevent the enactment of provisions that would lose revenue, including badly needed technical corrections, even when needed to simplify the law, correct inequities, prevent distortions of economic decision-making, or otherwise improve the law. Moreover, provisions are enacted without due care to their consistency with other parts of the law, producing a Code that lacks coherence and is inordinately complex.

Second, in a world in which the threat of a presidential veto implies that taxes cannot be raised explicitly, resort must be had to various types of politically innocuous "loophole closers," sometimes called "cats and dogs." These reforms generally have common characteristics. They are likely to have only limited applicability; otherwise they would cause a credibility problem for--and thus a veto from--a president who promises no new taxes. (Thus we would place limitations on the availability of the ITC for property leased to tax-exempt organizations in the "cats and dogs" category, but not repeal the ITC.) They

generally raise relatively little revenue, when considered singly; it is only by combining a number of these minor provisions that Congress can raise significant amounts of revenue.

They may constitute good tax policy, in the sense of redressing inequities and preventing tax-induced distortions in the allocation of resources. But they are generally quite arcane and complicated.

The Deficit Reduction Act of 1984 (DEFRA) is a prime example of this phenomenon. DEFA dealt with such matters as straddles, at-risk loss provisions, nonsimultaneous like-kind exchanges, related-party transactions, premature accruals, prepaid expenses, availability of the ITC on property leased to tax-exempt institutions, "golden parachutes," and distributions involving tiered partnerships--hardly important concerns for most taxpayers. Of course, DEFRA also contained some provisions of more general applicability.

Third, when tax reform occurs in a revenue-neutral context, it may be necessary for committee chairmen to use highly targeted provisions such as "transition rules" to buy support from their colleagues. In earlier days, when there was less concern for budgetary outcomes, that same support might have been obtained with provisions of more general applicability--and greater revenue cost.

The effects of highly targeted provisions are a mixed bag. They are not likely to add much to the complexity faced directly by most taxpayers, for whom they simply are not relevant. Beneficiaries of targeted tax preferences are unlikely to complain about complexity; as Surrey has noted, "no taxpayer group ever rejects a new tax preference on the ground it is complex."[4] On the other hand, they do adversely affect the ability of both private practitioners and tax administrators to master and deal with the Internal Revenue Code, including the regulations. Moreover, by adding to the length of the Code and to the number of forms and regulations, they contribute to an aura of complexity that, together with the blatant inequity of such provisions, undermines faith in the tax system.

Fourth, in an atmosphere in which every proposal for new expenditures must be accompanied by a proposed method of finance, too little attention may be devoted to technical details of the design of revenue measures. When tax law is grafted onto spending bills, sometimes almost as an afterthought, it is almost inevitable that complexity, inequities, and distortions will result.[5]

Furthermore, mistakes that further complicate matters are likely to occur when policy is made "under the gun" of reconciliation. Part of the added complexity results from the need to revisit and revise flawed legislation in order to rectify earlier mistakes. This is not to say that tax legislation should not be revisited. Legislation will inevitably contain flaws, whether for political reasons, honest errors in policy, or technical defects; in many such cases it may be possible to improve matters by revisiting. The point is that the need for revisiting to correct technical defects is likely to be greater when legislation is enacted in more of a rush. Revisiting is most likely to result in complexity not when it is motivated by a need to correct real flaws, but when it is used as an opportunity for special interests to change the law to suit themselves.

But the news is not all bad. The combination of a deficit crunch and the demands of revenue neutrality has forced greater congressional recognition of the fact that tax expenditures (subsidies implemented through the tax system) are not costless, and should compete against other possible uses of federal funds. If only budgetary expenditures are subject to control, the President and the Congress will be tempted to use tax expenditures to make an end run around the limitations. But if it is the deficit that is the object of control, this ploy will not work.[6] The lack of revenues also makes it much more difficult than before for a particular member of Congress to gain enactment of special-interest legislation that would create inequities and distortions and further complicate the system. Moreover, the pressure of budgetary discipline may induce the Congress to take action to reduce tax preferences that otherwise would survive intact. This certainly seems to have been the case in 1982, 1984, and 1986.

This paper examines the interaction between budget process and tax policy. Although it focuses on the impact of the budget process on the simplification and complication of the tax system, it also touches on issues of equity and neutrality and on the phenomenon of fiscal craziness.[7] Moreover, it also discusses how the reforms of the tax legislative process contribute to the problem created by budget processes. It does not address many of the quite different issues covered in McDaniel's excellent paper for the 1978 ALI-ABA conference on the political process of federal income tax simplification.[8] Nor does it address many of the fundamental decisions underlying the present U.S. income tax system, such as the choice between income and consumption as the basis of taxation,[9] the use of graduated rates,[10] or the choice of the married couple as the basic taxpaying unit.[11]

The next section describes the changes that have occurred in the budget process in recent years and the budgetary constraints under which policy-makers now labor. The third section is an attempt to differentiate several types of complexity, indicate the sources of complexity, and determine who experiences complexity. The fourth section provides examples of complexity taken from recent changes in the law. The fifth section discusses the congressional reforms and counterreforms that have rocked the tax-writing committees and altered their way of doing business since the 1970s. The sixth section indicates how the budget process contributes to complexity. The paper ends with some tentative suggestions on how to improve matters; they are intended to be provocative rather than definitive. Some readers may wish to skip directly to the sixth and seventh sections.

For the most part, descriptions of complexity in this paper are impressionistic and subjective; complexity is not quantified. Thus the paper points the way to the need for quantification of many of the effects mentioned. Among the many questions that might be addressed are, Which are the most complex provisions? To what extent is complexity inevitable in an income tax and to what extent is it avoidable, being the result of particular ill-advised policies? Are "loophole closers" any more complex than other provisions? To what extent is the complexity of certain rules offset by the greater simplicity of transactions they produce? Does targeted relief seriously complicate the law? Are tax provisions that are grafted onto spending bills extraordinarily complex? To what extent can complexity be traced to the reconciliation process?

THE BUDGETARY CONSTRAINTS

This section describes in general terms the origin and effects of the budgetary constraints that have operated on the tax policy process during the 1980s.

The 1974 Congressional Budget Act

The Congressional Budget and Impoundment Control Act of 1974 (hereinafter the "Act") has markedly changed the process of legislation on tax and expenditures, especially since 1980.[12] We need not be concerned with the details of the Act; the important point is that a "reconciliation resolution" passed by Congress specifies the amount by which taxes, spending, or both, is to be changed in order to meet budgetary targets. This has had the effect of centralizing power in the budget committees and weakening the tax-writing committees. In addition, the Act requires that each annual budget contain estimates of tax expenditures. (The concept of tax expenditures is discussed in the third section below. Though not strictly correct, for present purposes tax expenditures can be thought of as deviations of taxable income from economic income.)

After a tentative start, the Act came to exert an important influence on budgetary politics, including the making of tax policy. In 1980, for the first time, instructions to the tax-writing committees mandated a one-year increase of revenues (of $4 billion)--a mandate that was carried out.[13] "Largely unnoticed at the time except within the halls of Congress, the reconciliation process was successfully implemented, and the tax legislative process has not been the same since."[14] Since then, reconciliation has led to enactment of the following tax bills, with their three-year revenue yields: 1982--(TEFRA)--Tax Equity and Fiscal Responsibility Act of 1982 98.3 billion; 1984--DEFRA--$50 billion; 1985--$6.6 billion; 1986--$5.7 billion; 1987--$38.2 billion.[15] We will return to the process and nature of these changes subsequently.

The Act contributes to fiscally responsible tax policy because the budget resolution indicates to the revenue committees the amount of money that must be raised through tax policy for the next three fiscal years. By setting a particular revenue target, the resolution sets the stage for discussions of trade-offs involving alternative ways to raise that amount. The tax expenditure budget helps in the evaluation of such trade-offs by quantifying the revenue effects of various preferences, as well as by publicizing the use of this avenue of supporting private activities. (The tax expenditure budget is sometimes characterized as a "hit list" for tax reformers.) Whether this process makes for a simpler system is the subject of this paper.

The 1981 Tax Cuts

The Economic Recovery Tax Act of 1981 (ERTA) reduced federal revenues by an amount estimated to exceed $700 billion over five years. Although the TEFRA and DEFRA increased revenues substantially, the former by rescinding part of the 1981 tax cuts, on balance taxes remained substantially lower than they would have been under pre-1981

law.[16] Since spending was not cut by a corresponding amount, large deficits emerged. Thus ERTA, in conjunction with the slowdown in economic growth, indexing of the individual income tax, and the end of the decline in defense spending (to be discussed subsequently), set the fiscal stage for the remainder of the 1980s. (It is probably largely responsible for the Gramm-Rudman legislation, discussed subsequently.) The Congress has been loath to adopt any proposal that would further increase the deficit.

Minarik goes even further in tracing the long shadow cast by the excesses of ERTA: He writes:

> [T]he 1981 Act reduced revenues drastically and assured that subsequent revenue acts would not reduce revenues further. Rather, later acts became a search for revenues which, given the political landscape, did not tolerate rate increases. This almost preordained the elimination of tax preferences. Preference closing was made easier by the outrageous features of the 1981 Act, in particular safe harbor leasing, that gave the public the perception that many of America's wealthiest and biggest corporations were paying no tax.[17]

The End of the Free Ride

For much of the period from the mid-1960s until the 1980s, the U.S. government was able to increase domestic expenditures and tax benefits to special interests with relatively little legislated pain in the form of higher taxes. This is true, because of, inter alia, sustained economic growth, bracket creep in the individual income tax, and the relative decline in the defense budget. These sources of domestic funding were essentially eliminated during, if not before the beginning of, the 1980s.

Slowing Economic Growth[18]

During the post-Korean War part of the 1950s, real GNP grew substantially faster than real outlays of the federal government (2.7 percent versus 1.2 percent annual increases), reflecting in part a continuation of the demobilization after the war. The 1960s saw more rapid economic growth (4.4 percent per annum); this made possible substantial growth in both defense and nondefense spending, but an even more rapid growth of spending (4.9 percent) led to increased budget deficits. During the early 1970s, the rate of growth fell markedly, to the neighborhood of 2.5 percent, where it has remained. Although the rate of growth of federal spending has also declined, it has continued above the rate of economic growth, producing even larger deficits than in the 1960s.

Inflation, Bracket Creep, Fiscal Dividends, and Indexing

Until passage of the 1981 tax reform, the income tax system of the United States was totally unindexed; that is, when prices increased, figures stated in monetary terms, such as personal exemptions and bracket limits in the rate tables, were not changed except through explicit legislation.[19] As a result, the inflation that began in the late 1960s produced the phenomenon of "bracket creep," a situation in which taxpayers with a given real (inflation-

adjusted) income found themselves in increasingly higher tax brackets. Besides undermining the progressivity of the tax system (as described by the personal exemptions and rate structure initially found in the law), bracket creep created a tendency for the system to generate "fiscal dividends."[20] These dividends were manifested in tax collections that grew, as a percent of GNP, even in the absence of legislation to raise taxes.[21]

The additional revenues resulting from the absence of indexation were used for a variety of purposes. First, taxes were cut several times to offset the effects of bracket creep. Verdier has noted that sharp increases in individual tax burdens, stimulated often by bracket creep, have historically led to major tax bills.[22] In a similar vein, Leonard notes:

> Inflation-driven, bracket creep was the single most important force for legislative change throughout the 1970s. The Tax Reduction Act of 1975, the Revenue Adjustment Act of 1975, the Tax Reform Act of 1976, the Tax Reduction and Simplification Act of 1977, and the Revenue Act of 1978 were all enacted to offset the effect of automatic increases in individual tax burdens resulting from inflation. All these bills were designed to avoid what at the time was called "fiscal drag."[23]

Tax reduction did not take the form of only--or even primarily--rate reduction. Increased revenues were used to finance increased tax expenditures. Tax expenditures increased from just over half of income tax revenues in 1974 to roughly 90 percent in 1984, the year before indexing took effect; by 1986, before enactment of the Tax Reform Act of 1986 (TRA '86), tax expenditures were estimated to be slightly larger than income tax revenues.[24]

One of the important changes made in the 1981 law was the provision that, beginning in 1985, many of the monetary figures in the tax code would be indexed; that is, they would be adjusted annually to reflect increases in prices. This has had the important effect of eliminating bracket creep and the fiscal dividends it produced. No longer can the federal government rely on automatic increases in tax revenues created by inflation to cause tax collections to increase more rapidly than GNP; by and large, if it wants to increase spending or provide special-interest tax expenditures, it must be willing either to raise taxes or incur increased deficits.[25] Whereas eight of eleven major revenue measures passed from 1975 through 1981 lost revenue in the first three years following enactment, fourteen of the seventeen major revenue measures enacted since 1981 have raised revenue.[26] The dividing point was, of course, ERTA, which lost revenue and introduced indexing. Leonard notes that the enactment of indexing as part of ERTA marked the end of administration projections of balanced budgets.[27]

Ending the Decline of Defense

In 1967, at the peak of the Vietnam buildup, national defense absorbed 9 percent of GNP. By 1978 that percentage had dropped to below 5 percent. The difference, more than 4 percent of GNP, represented an enormous additional dividend that could be diverted to nondefense uses (including tax reductions) without the need to increase taxes.[28] At 1980

levels of GNP, the "defense dividend" amounted to more than $100 billion; at 1988 levels of GNP, it amounted to roughly $200 billion.

The fall in the fraction of GNP devoted to defense had ended by the time President Reagan took office, and the defense buildup, begun under President Carter and continued under Reagan, sharply reversed this downward trend in the relative importance of defense. By the mid-1980s the percentage of GNP devoted to national defense had recovered to 6.5 percent. Expansions of domestic programs and increased tax expenditures could no longer be financed in part by the funds made available by the relative decline in the defense budget; indeed, proponents of defense and nondefense spending (including tax expenditures) had become engaged in a highly competitive battle for budget dollars.

"No New Taxes"

Three actions taken under Reagan administration--the 1981 tax cuts, indexing of the individual income tax, and continuation of the reversal of the relative decline in defense spending--created an enormous budget deficit and made it difficult, if not impossible, to increase spending without either increasing taxes or incurring even greater budget deficits. But Reagan, in statements made early and often during his presidency, made it clear that he would not tolerate a tax increase. During the 1988 presidential campaign George Bush used the phrase "Read my lips: No new taxes," to reiterate Reagan's promise. These promises fed a popular "tax revolt," which had been evident in state capitals but was thus far largely latent in Washington.[29]

They made everyone in Congress reluctant to try to "bell the cat" of budget deficits by proposing a tax increase and thus evoking the threat of a presidential veto. If taxes were to be raised, it would need to be by the "cats and dogs" approach rather than by explicit increases in taxes that would hit a large portion of the population.

Of course, the cats-and-dogs approach was used in 1982 and 1984. Then it was extended in a revenue-neutral context in TRA '86. Minarik has written:

> [T]he tax rate cuts had become so much a part of the economic policy baseline, not to mention of the President's agenda, that raising revenue required plugging loopholes in the tax base rather than raising rates. The process exposed many obsolete and unjustifiable tax preferences . . ., and it convinced many members of Congress that tax preferences could be repealed without causing the sky to fall in.[30]

For the first three years after TRA '86 became law, there seems to have been an implicit contract not to reopen the Code for further revision, in part because many believe that to do so would result in the "unravelling" of tax reform. (One can only speculate whether such unravelling would occur in a revenue-neutral context or include a tax increase. Certainly tax reform was opposed in part because of the prospect that once the base had been reformed, rates would be raised to reduce the deficit.) As this is being written, this contract may be dissolving, in large part because President Bush apparently has no commitment to tax reform.

Revenue Neutrality

During the process that led to TRA '86 Ronald Reagan made it clear that tax reform was not to be used as a front or an excuse for a tax increase. Yet, given the size of actual and projected budget deficits, it was also clear that tax reform should not result in reduced revenues. As a result, the Treasury Department, in its 1984 report to Reagan, established "revenue neutrality" as one of the guiding principles for tax reform: Tax reform should "leave revenues essentially unchanged from what they would be under current law."[31]

The requirement of revenue neutrality has been described as one of the keys to the eventual passage of TRA '86, a bill that could be characterized as fundamental reform.[32] Acting initially on a "business as usual" basis, the Senate Finance Committee began by yielding to so many requests for exceptions that its tax reform plan would have lost an estimated $30 billion. Only by changing course and adopting the principle that any revenue loser had to be matched by a provision that would restore the lost revenue could the committee maintain the discipline to produce the historic agreement. Thus it virtually retraced the steps the House Ways and Means Committee had made less than a year earlier.

Revenue neutrality turned the tax reform process into a "zero sum" game in which the tax benefits saved or expanded for one group had to be matched by the loss of benefits by another group. As a result, the business community was split--or even fragmented; instead of presenting a monolithic front (what Birnbaum and Murray call a "killer coalition)", business, as it had often done in the past, business took an "every man for himself" attitude that proved disastrous to its cause.[33]

The combination of the federal deficit and the revenue-neutral mind-set it helped produce may have helped change the way the Congress views tax policy. There seems to be less of a tendency to adopt provisions for tax reduction without caring about the revenue consequences. This was seen perhaps most clearly in the 1986 tax reform exercise.

The Gramm-Rudman-Hollings Targets

Growing concern over the size and intractability of budget deficits led to the 1985 enactment of the Gramm-Rudman-Hollings bill, which specifies targets for deficit reduction. Under the Gramm-Rudman-Hollings Act, deficits are to be reduced by specified amounts each year until budgetary balance is reached in 1993 (1991 in the original legislation). In the absence of agreement on a budget that would achieve these targets, the president is to mandate an across-the-board sequestering of funds. Such sequestration would cut both defense spending and nondefense spending not explicitly exempted equally; social security, medicare, and interest on the national debt are among the exempt expenditures.

The Gramm-Rudman-Hollings Act is intended to impose discipline on an otherwise undisciplined Congress (and President). In principle, expenditures and tax breaks cannot

be legislated willy-nilly without regard for their budgetary consequences; indeed, in the absence of extraordinary economic growth, budgetary expenditures, tax expenditures, or both must be reduced or tax rates must be raised if the targets are to be met. An important result of Gramm Rudman Hollings might be described as the requirement of "revenue neutrality at a lower level of deficit". That is, the deficit must be reduced by a specified amount. Given that, any tax benefit that survives or is increased must be matched by cuts in another. (Thus budgeting becomes a negative-sum game.)

As a result, some expenditure proposals are accompanied by proposed methods of finance. (This is most common in the case of expenditures subject to the jurisdiction of the tax writing committees, especially Ways and Means.) In addition, because of the discipline of the Gramm-Rudman-Hollings targets, proposals for changes in tax law that would lose revenues are, almost of necessity, framed in a revenue-neutral context; that is, they are accompanied by proposals for recouping the lost revenue.

The Gramm-Rudman-Hollings targets have been exceedingly difficult for the Congress to meet. One result has been the increasing use of budgetary "gimmickry" to circumvent the spirit of the law while observing its letter, what has earlier been called "fiscal craziness."

Undue attention is devoted to the short-range impact of tax changes, to the neglect of long-term effects. A prime example is the recent spate of proposals to cut the tax rate applied to long-term capital gains for only one or two years and index basis after that; this is further examined below. As this is being written, there is talk of "back-loaded IRAs," individual retirement accounts into which taxpayers make after-tax deposits, receiving tax exempt returns of both principal and interest. This is not necessarily a hair-brained idea if one wants to restore IRAs; indeed, such accounts are an integral component of the so-called prepaid methods of implementing a direct tax on consumption rather than on income.[34] But it is no accident that talk of introducing yet a third form of IRA that postpones revenue loss--and of the option of rolling over funds from conventional tax-deferred IRAs to the new back-loaded variety by paying tax currently on the amounts rolled over--is occurring in the environment of Gramm-Rudman-Hollings. The revenue-losing effect of back-loaded IRAs would not be experienced until funds are withdrawn; by comparison, under a conventional IRA, the revenue loss occurs when funds are deposited and as interest is earned. A potentially more important kind of craziness, also predicated by budgetary stringency and the desire to hide the true costs of public policies, involves the requirement (sometimes called "mandating") that private firms provide services that traditionally have been provided by the public sector.[35] The effects of this type of regulation, which can be characterized as quasi-tax/quasi-public spending, are beyond the scope of the present paper.[36]

Another result has been to divert attention from eliminating the deficit to meeting the Gramm-Rudman-Hollings targets for the year.[37] One possible effect in the tax area is to focus on relatively smaller changes that would help meet the immediate targets, instead of on larger changes, including changes in rates, that would eliminate the deficit.

Synthesis

The requirement of revenue neutrality implied that in 1986 tax reform was a zero-sum game; any tax benefits left intact must be financed by eliminating or not conferring other benefits. This process may improve the tax system in many ways, but it need not contribute to simplicity.

Looking to the future, similar results can be expected, for the combination of forces identified above create pressures that change the nature of decision-making on tax policy. The 1981 tax cut--even after the 1982 and 1984 Acts--created an enormous federal budget deficit that worries many observers. The slow down in economic growth, the end of the decline in defense spending, and the elimination of fiscal dividends based on bracket creep that was accomplished by indexing imply that there will be no easy solution to the deficit problem; either expenditures (or the growth of expenditures) must be cut or taxes must be raised. And yet the Gramm-Rudman-Hollings Act requires that the deficit must be cut. Since President Bush threatens to veto a tax increase, revenues can be raised only in ways that do not appear--at least to Bush--to increase taxes. That generally means the use of base broadeners (the "cats and dogs" approach) rather than rate increases. This, in turn, may increase complexity.

VARIOUS KINDS OF COMPLEXITY

Rather than discussing complexity as an undifferentiated glob, it is useful to try to break it down in various ways. This section does that; it discusses (1) three different types of complexity, (2) five different sources of complexity, and (3) the important question, "complexity for whom?"

Three Types of Complexity

I do not attempt a precise definition of either simplicity or complexity. McDaniel expresses the basic idea when he writes, "Whether by 'simplification' one means more easily understood statutory language, increased ease of tax administration, greater certainty in planning, more easily understood forms, or more coherent resolution of tax issues by the courts, the fact is that all of these concerns derive fundamentally from the tax statute itself."[38] It may, however, be worthwhile to add several points. First, "simplicity" is being accorded essentially its dictionary definition; it is not being used as a synonym for fairness, what I have elsewhere called "simplicity for the other guy."

Second, it is useful to distinguish between several aspects of simplicity (and hence complexity) that are subsumed in the foregoing quotation from McDaniel.[39] The first is what might be called "compliance simplicity," which is a matter of keeping records, filling out forms, etc. It is probably primarily this type of simplicity that concerns most taxpayers who have relatively simple financial affairs.

"Simplicity of rules" is lacking when the Code and its supporting regulations can be interpreted only by "a tiny priesthood of lawyers and accountants"--and even by them only with great difficulty. Again, most taxpayers do not confront truly complicated rules--although it is probably appropriate to recognize that complexity is almost certainly in the eye of the beholder.

Those with complicated financial affairs are often affected by what might be called "transactional simplicity," the notion that under a simpler system, financial deals and economic decisions need not be structured with an eye to their tax consequences; this is a close cousin to--but not the same as--economic neutrality. Of course, the presence or absence of this type of simplicity can be traced directly to the provisions in the Code. This type of simplicity is likely to be of greatest relevance for corporations and for individuals who are either relatively wealthy or engaged in business for themselves.

There are cases in which provisions that complicate rules or compliance lead to transactional simplicity. As Bradford has written, "Rules with a high degree of economic consistency serve transactional simplicity, although they may impose costs in the form of compliance and rules complexity."[40] For example, the complicated provisions of TRA '86 that substantially eliminate tax shelters (at-risk rules, passive loss rules, etc.) simplify economic decision making and create transactional simplicity. In the long run, to the extent that such rules eliminate tax shelters, they indeed simplify the system on balance.[41] If the tax benefits of prior tax shelters are eliminated, it is only during the period when old investments are subject to the new rules that the net complexity of the system increases.

Sometimes transactional complexity is increased by tax reform, including reforms that are not even effective in reaching their (supposed) objectives of equity and economic neutrality. For example, when safe-harbor leasing was repealed, it became necessary for taxpayers to incur greater complexity in structuring leasing deals that would pass muster under the tighter rules.

Five Sources of Complexity

In considering the interaction between budget process and simplicity, it is useful to distinguish five types of provisions that complicate the Code.[42] These are (1) rules necessary for the accurate definition of real economic income, (2) provisions creating tax expenditures, (3) "backstop" provisions intended to prevent the abuse of tax preferences or the appearance of inequity, (4) transitional rules, and (5) complications that arise because the tax system lacks internal coherence. Although the distinctions are far from watertight, for reasons to be specified subsequently, they do help to organize the discussion that follows. The five types of complexity are described in the remainder of this subsection; one category, tax expenditures, is considered in greater detail at the end of the subsection.

Income Definition Rules

The first source of complexity consists of provisions that are necessary for the accurate definition of a tax base that is roughly consistent with real economic income. (Since the

classic definition of economic income, consumption plus the change in net worth, is commonly associated with the names of two economists, Robert Haig and Henry Simons, the term Haig-Simons income will sometimes be used interchangeably with the term economic income).[43] We might call these necessary or appropriate income definition rules.

Some income definition rules result from the need to draw lines in inherently fuzzy areas. For example, under what circumstances should deductions be allowed for meals, entertainment, and expenses away from home or for the expenses of a home office? Short of meat-ax approaches that say that no such expenses are deductible (or that all are), this type of complexity seems inevitable; but provisions such as the 2 percent floor on miscellaneous expenses in the TRA '86 reduces (and perhaps eliminates) compliance complexity for many taxpayers who expect at the beginning of the year to be below the threshold.

Much complexity comes from a quite different source. In principle, economic income includes accrued income, as well as income that has been realized. Since accruals are often not directly observable, it is necessary as a practical matter (as well as a matter of policy, in cases in which taxation based on accrual would be administratively feasible but politically unpopular) to base taxation on realization. (In addition to income definition rules that are broadly consistent with an economic definition of income, there are rules providing for the deferral of recognition of income. Some of these might best be treated as tax expenditures.) Yet in some cases it is not sufficient to base the system on a purist (cash flow) interpretation of realization, since to do so would be overly generous to the taxpayer, who generally can control the timing of realization; rather a mixture of realization and accrual rules is provided. Thus many of the most important of these rules involve issues of the timing of recognition of income and the deduction of expenses. The rules governing depreciation allowances, capitalization of costs of carrying inventories, costs of multi-period production, original issue discount obligations, installment sales, reserves for bad debts, and accruals for vacation pay would be examples of this type of provision.[44] Income tax rules governing such timing issues are inevitably complicated.[45]

The growth in complexity of this kind--and the purpose it serves--can be appreciated from the evolution of the rules dealing with original issue discount (OID).[46] The first OID rules, enacted in 1954, were intended merely to prevent OID from being characterized as capital gains; before 1969 the interest represented by OID was not taxed until received at the time of redemption. Naturally this led to abuse and inequity, as taxpayers took advantage of opportunities for tax arbitrage. While the rule adopted in 1969 (current taxation based on straight-line accrual of implicit interest), complicated compliance and administration, it only approximated the true pattern of accrual and was thus only partially successful in preventing abuse and inequity, especially during the periods of high interest rates of the 1970s. As a result, in 1982 accrual based on compound interest was adopted. This rule, while extremely complicated, failed to cover debt issued by individuals and cases in which both debt and property were publicly traded. These cases were brought under the new rules by the 1984 Act.[47]

Many such timing rules are likely to be complicated and to cause considerable frustration for taxpayers and the practitioners dealing with their tax matters. This is

especially true when tax rules diverge from generally accepted accounting principles, as do the rules for the capitalization of the costs of holding inventories.

But for several reasons, it is necessary (or at least desirable) to have rules that provide that taxable income approximates economic income fairly closely.[48] First, in the absence of such rules, the income tax will not be fair, in the sense of treating all taxpayers with the same economic income similarly regardless of the source of their income. Second, and perhaps equally important, the system may not be perceived to be fair. The public is not likely to comply voluntarily with a system seen to be unfair. Third, without adequate rules, the income tax will not be neutral; because income from various sources is treated differently, investments and other business decisions will be motivated by tax considerations rather than only by business considerations.

Finally, and of particular interest for the present discussion, the absence of adequate rules can give rise to even greater complexity. For one thing, factoring tax considerations into business decisions can be expected to complicate decision making, creating transactional complexity. Beyond that, the tax law itself is likely to become more complicated over time, as taxpayers and their representatives look for ways to exploit "loopholes" and the government attempts to stop them by both fine-tuning of the basic law or the enactment of what are called "backstop" provisions in the following discussion.[49] For this reason, apparently simple rules do not necessarily make for simplicity. Indeed, deviations of taxable income from economic income that seems simple on face can cause great complexity. The accelerated cost recovery system (ACRS) was simple, but it created complexity. (This is discussed below.)

An additional potential source of considerable complexity, but one not yet found in the Code, is inflation adjustment in the measurement of income from business and capital. Essentially, it is necessary to adjust depreciation (and similar) allowances, cost of goods sold from inventory, the basis of capital assets, and interest income and expense if real income is not to be mismeasured.[50] While inflation adjustment would undoubtedly complicate both rules and compliance, it would reduce transactions complexity, especially in times of high inflation, by increasing the correspondence of taxable income to real economic income. Of course, it is also required for equity and neutrality.

Some complexities associated with income definition rules exist because current law attempts to impose more than one tax on a certain streams of income, but only one tax on other similar flows of income. This distinction is especially important in the case of the taxation of equity income flowing from corporations to individual shareholders, compared with taxation of income earned in partnerships.[51] (Whether this is merely part of the general income measurement problem or deserves to be treated as a separate form of complexity, presumably incoherence (to be discussed subsequently), is left as an open question.) For example, it is necessary to distinguish between interest and dividends, since both are taxable to the individuals receiving them but corporations are allowed a deduction for the former but not the latter. Moreover, it is necessary to have elaborate rules that take account of the many ways relations between partners and partnerships can be structured. Much of the debate over such provisions as at-risk rules and the uproar over the repeal of General Utilities can be traced to this source. Yet attempting to treat interest

and dividends similarly, by "integrating" the two income taxes or providing relief for double taxation of dividends, has its own complications.[52]

It is useful to divide this category of complexity inherent in income definition rules into two further groups, again realizing that the division is not watertight. On the one hand there are the fundamental decisions that determine the basic nature of the income tax, for issues such as (1) whether there is to be a separate corporate income tax or an integrated system, and what is the nature of the system of integration (if one is to be provided); (2) whether capital gains are to be taxed as ordinary income or preferentially, and what is the nature of such preferential treatment; (3) whether there is to be a system of inflation adjustment in the measurement of income from business and capital, and, if so, what type of system is it; and (4) whether depreciation allowances are intended to track economic depreciation or be more (or less) rapid, and what is the nature of the available rules for acceleration. We will call these basic rules for income definition.

Once these basic rules have been chosen, there remain myriad details to be settled before the basic rules can be implemented. These include matters commonly handled in regulations under current practice, but many issues now determined legislatively also properly belong in this category. These might be called derivative rules of income definition. Recent discussion of tax reform provides a perfect example of the possible distinction: It makes little sense for the Congress to be involved in such details of tax law as the depreciation treatment of tuxedos.

Tax Expenditure Provisions

The second type of complicating provision is not needed to define economic income accurately. Rather, these provisions represent (often explicit and intentional) deviations of taxable income from economic income. Some of these provisions are adopted to encourage certain activities; the continuing exclusion of interest on state and local securities is one example. Others are adopted with the express purpose of simplifying the system. Thus investment in intangible capital and expenditures on research and development (R&D) are expensed in part because of the inherent difficulty of distinguishing capital outlays from current expense and of specifying appropriate depreciation schedules. An example that combines the two objectives of incentives and simplification would be the expensing of capital assets (and of R&D); expensing encourages investment, and it is simpler than economic depreciation (at least if we ignore problems of recapture and tax shelters, to be considered subsequently).

Some provisions are intended to provide relief to certain groups of taxpayers, but not necessarily to simplify returns or encourage the affected activity. Special benefits to the blind and the elderly are examples of this category. Many such provisions are quite complex, because of rules intended to limit their availability and because of the implied revenue loss.

Provisions in this second category are sometimes called tax expenditures to indicate their similarity to budgetary expenditures.[53] In essence, because of deviations of the tax base from economic income, federal dollars are spent by not collecting them.[54] The

concept of tax expenditures was given budgetary legitimacy in the Budget Act of 1974.[55] By law, each annual budget submitted to the Congress must now contain estimates of tax expenditures.[56] McDaniel has observed that "the use of tax expenditures is the single biggest cause of complexity in our tax system."[57]

Depending on their specificity, tax expenditures can be characterized as "general" or "targeted", (that is, available only to a small number of taxpayers). Fortunately, little use has been made of targeted tax expenditures, aside from the targeted transition rules to be discussed subsequently. Following the suggestion made in connection with income definition rules, it is useful to distinguish between the basic rules for tax expenditures, which the Congress must determine, and the derivative rules that spell out details that could be left to others.

"Backstop Provisions"

Congress has shown an amazing reluctance to adopt income measurement rules that would cause taxable income to approximate economic income. There are a number of explanations for this, including failure to understand the issue and its importance in particular cases, the complexity of some of these rules, and (especially) the desire to provide tax benefits (tax expenditures) in others. Whenever the absence of accurate income measurement has conferred significant tax benefits, taxpayers have typically responded by reaping the tax savings. In some instances the result has been abuse or the perception that the system is unfair; the phenomenon of wealthy individuals and corporations paying little or no taxes is commonly interpreted as politically unacceptable, even if totally legal means are used to reduce taxes.[58]

Rather than reacting by eliminating (or substantially reducing) the distinction between taxable and economic income, the Congress has sometimes adopted a variety of "backstop" provisions that limit the latitude for abuse the impression that the system is unfair, or both. This was especially true in TRA '86, which included, inter alia, a tighter alternative minimum tax (AMT) on individuals, a new AMT on corporations (including one based on book income), a new limit on the deduction of passive losses, and tighter limits on the deduction of interest expense.[59] The AMT based on book income would guarantee that corporations that showed a positive book income would pay at least some tax. Limitations on the ability to use investment tax credits to offset income tax can be traced to the same concern; they have no other apparent justification.[60]

These backstop rules are almost inevitably complex. (For example, it has been noted that there are more than a half-dozen ways to treat various types of interest expense; see subsequent "Interest Deduction" section below.) They would not be needed in a system in which taxable income did more closely approximate economic income. "Thus the use of tax expenditures has produced a double level of complexity in the tax laws; first when the provision is introduced and, second, when tax reformers seek to limit the adverse effects of the special tax provisions on tax equity. The net result has been a tax system that spirals toward ever-increasing complexity."[61] Yet the very existence of these rules may actually reduce transactional complexity enough to produce a net reduction in complexity.[62] This possibility is discussed further below.

To the extent that they restrict access to the benefits of tax expenditures, backstop rules can be interpreted as a sign of congressional schizophrenia: benefits are given with the ordinary tax expenditure provisions and then taken away with the backstop provisions. In such cases they are presumably addressed at the perception of inequity, since the underlying provision that creates the impression of abuse continues to have congressional approval.[63]

Finally, it must be acknowledged 1) that basing a system entirely on taxation of accrued but unrealized income suffers from overwhelming political and practical problems and 2) that any system based substantially on realization will inevitably contain opportunities for taxpayers to play games, unless such opportunities are carefully foreclosed by backstop rules such as limitations on interest deductions and the deductibility of capital losses.

As with income definition rules and tax expenditure rules, it seems to make sense to distinguish between the <u>basic backstop rules</u> that Congress should determine and the <u>derivative backstop rules</u> that it need not establish explicitly.

Transition Rules

Transition rules are provisions that exempt income and expense related to commitments made under prior law from ordinary treatment under the new law. Thus the Internal Revenue Code still contains many provisions exempting income earned before the introduction of the income tax in 1913. More recently, each time the investment tax credit (ITC) has been suspended, care has been taken to be ensure that investments for which there had been a firm commitment before a given date (usually the date of a presidential proposal or the announcement of congressional consideration of the proposed change) continue to qualify for the credit, even if placed in service after the date of suspension. On the other hand, similar care is taken to ensure that only investments for which commitments are made after a certain date benefit from reinstatement of the ITC.

In principle, transition rules can provide an important element of equity, by insulating those who have made (have not made) such commitments from the retroactive effects of harsh changes (benefits) in the law. Unfortunately, they can create considerable complexity, because it is necessary to have rules for the treatment of many different transactions or components of income. For example, every time depreciation schedules are changed, it is necessary to create a distinction according to whether assets were placed in service before or after the change. If indexation is adopted for capital gains, it will be necessary to value the entire capital stock as of the date the indexation begins, or to have some rule for the determination of the fraction of gain to tax in the case of assets held before introduction of indexing.

Transition rules can also be used as "sweeteners" to buy the approval of recalcitrant members of Congress for tax reform. So used, they generally detract from equity. (This is discussed in a subsequent section below.)

In what follows it will be useful to distinguish between what might be called "true transition rules of general applicability" and "transition rules used as sweeteners." The

latter include both true transition rules that are highly targeted and targeted "transition rules" that are really permanent benefits; the latter are generally more accurately characterized as targeted tax expenditures.

"A Horse Designed by a Committee"

Some complexity can be identified directly with none of the foregoing four types. Rather, the tax law is complex in part because it lacks coherence. Incoherence occurs because tax policy has been put together badly--because tax policy is, in the words of the old definition of a camel, a horse designed by a committee, and a committee operating continuously and often under pressure for many years, at that.[64] Witte has described the problem as follows:[65]

> Over the years, in trying to respond to the demands of diverse groups, to meet the political needs of decision makers, and--so very important--to correct, adjust, and fine-tune the system, the income tax as a fundamental and ostensibly equitable means of raising revenue has been slowly but continuously eroded. ... What has emerged may be a versatile and flexible policy tool, but it is also devastatingly complex tangle of diverse legislative provisions and administrative rules.[66]

Handler has identified the following examples of why the tax law is complex: related provisions that need rationalization and coordination; overly broad and imprecise language that begs confusion and misinterpretation; overly complex solutions to admittedly complex problems; "quick fixes" legislated to deal with problems perceived to be pressing without adequate understanding of their implications; rules intended to provide limited relief that turn out to have wider applicability, leaving essentially legislative tasks to be settled by regulations; and complexity resulting from repeated uncoordinated amendment of the statute.[67]

Among the many cases of incoherence in the Code are the multiplicity of rules defining related parties, those governing the division of interest expense among various "baskets", and the nondiscrimination rules. (The second and third of these are discussed further below.) A particularly distressing type of incoherence is that affecting those just above the tax threshold who must deal with the maze of incoherent provisions for filing status, marital status, number of exemptions, standard deduction, earned income credit, and child care credit. Schenk notes, "For many taxpayers, the tax return and instructions present a bewildering morass of rules which cannot be easily mastered."[68] Under a rational policy there should be fewer such rules and the rules would be consistent. The problem is that various definitions and limitations have been added to the Code over the years as the need has arisen, without due regard for coherence.

This list is almost certainly incomplete. The point is that provisions that fall into one or more of the foregoing categories (income definition, tax expenditure, backstop, and transition) are put together in a way that lacks logical coherence and therefore creates complexity. Minarik, in regard to the Tax Reform Act of 1976 has written, "[I]n its further tinkering with the tax code provision by provision, and in its restriction and modification

of preferential provisions rather than outright repeal, this Act continued the complication of the law and of economic choices."[69]

A further source of complexity is what Chapoton, following Ward Hussey, has labeled the use of vertical drafting, in which many concepts closely related to others in the Code are included, with variations, in different sections of the law. By comparison, in horizontal drafting each key concept is set out in one place and then incorporated by reference in other sections. The result would be greater consistency in the treatment of similar factual situations, and thus less incoherence and less transactional complexity.[70]

Making tax policy "under the gun" of reconciliation almost certainly adds to incoherence. Handler notes, "The lack of internal coordination and the overwhelming complexity of its provisions have been characteristic of the Code for many years." Yet he notes, "The budget reconciliation procedure, however, has caused these problems with the legislative process to be exaggerated."[71]

Which Is Which?

As indicated earlier, the distinctions between the five types of complexity that have been identified are far from watertight. Yet it would seem that most practitioners with a basic understanding of the economics of income measurement would have little difficulty knowing into which category to place many provisions. For example, the OID rules are clearly income measurement rules; they are not tax expenditures, backstop rules, transition rules, or the result of incoherence. The ITC is just as clearly a tax expenditure, and the rules for when it is and is not available (in the case of suspension or reinstatement) are clearly transition rules. Moreover, virtually every knowledgeable observer would probably agree that the various backstop provisions listed earlier (and others) are exactly that; they are not required for accurate income measurement, they are not transition rules, they certainly do not provide tax expenditures, and they are not just the result of unintended incoherence in the Code (incoherence in the minds of the members of Congress, perhaps, but not in the Code).

Probably the most difficult problem of definition involves the distinction between income measurement rules and tax expenditures. Defining tax expenditures is no easy task.[72] The description of provisions that complicate the tax law in the previous section began with a two-way distinction of provisions that are needed to approximate economic income and those that represent deviations from that definition. It then went on to identify the second group with tax expenditures, a concept that now appears in U.S. law. But it should be recognized that the legal or budgetary definition of tax expenditures is not couched in terms of deviations from a pure definition of economic income. Rather, it is recognized explicitly that while the Haig-Simons definition of income is a useful starting point in defining tax expenditures, practical difficulties render implementation of a purist measure of tax expenditures impossible. Special Analysis F of the 1976 budget, the first to be prepared after the Congressional Budget Act of 1974 and the first to contain the required analysis of tax expenditures, notes, that "Income tax provisions resulting in tax expenditures are defined as exceptions to the 'normal structure' of the individual and corporate income tax." It goes on to list the following components of a normal tax system

that would be classified as tax expenditures under a strict application of the Haig-Simons definition but are not so classified in the special analysis: unrealized capital gains and losses, imputed income on owner-occupied housing, government services received in kind, foreign tax credits, and treatment of corporations and individuals as separate entities. It acknowledges explicitly with regard to depreciation, that "In the world of practical affairs, there is no single, correct number." Yet it noted unequivocally that expensing of capital assets would constitute a tax expenditure.[73]

In its 1983 budget the Reagan administration actually changed the baseline for calculating the tax expenditure budget. Rather than using the "normal structure" of former years, which the Joint Committee on Taxation and the Congressional Budget Office continued to use, the 1983 tax expenditure budget was calculated using a "reference tax" structure as its benchmark. Rather than relying on an external standard such as the Haig-Simons definition, the 1983 budget used the "reference tax" as an internal standard. It argued as follows:

> [F]or a provision to involve a tax subsidy, two conditions are necessary:
>
> --The provision must be "special" in that it applies to a narrow class of transactions or taxpayers; and
> --There must be a "general" provision to which the "special" provision is a clear exception.[74]

The most important result of this redefinition of the tax expenditure concept was the elimination of ACRS and the ITC from the list of tax expenditures.

The reasoning underlying this change was not compelling to some, who saw the change as converting the tax expenditure budget into a "political tract."[75] The 1986 budget, and those prepared through the remainder of the Reagan administration, (that is, through fiscal 1990), resorted to a compromise in which estimates of tax expenditures are reported under both "pre-1983" and "post-1982" concepts.

More on Tax Expenditures

An example is presented to illustrate the problems that can result from (1) failure to have adequate income definition rules, (2) the conscious decision to modify such rules to create tax expenditures, or (3) the use of ad hoc methods either as a substitute for satisfactory explicit rules or to override tax expenditure rules.

Deviations of taxable income from economic income cause problems. As noted previously, these problems can be generally characterized as inequity, perceptions of inequity, economic distortions, and complexity.[76] Moreover, they may give rise to political pressures for complex backstop provisions to prevent the perception of abuse. In some instances, on the other hand, such deviations can improve equity, perceptions of equity, and simplicity, and at least as seen by some, they can improve the allocation of resources rather than distorting it. The question is, in each case, whether the particular benefits of deviations are worth the accompanying costs.

Accelerated depreciation allowances such as ACRS provide a useful illustration of the problems and the benefits that can arise if income is not measured accurately, either by inadvertence or by design.[77] The potential benefits of accelerated depreciation are discussed first, and then the problems it causes.

Accelerated depreciation, at least in its ACRS version, is said to be simpler than economic depreciation; after all, there are no records to keep other than the original date and purchase price of the asset. It is also said to serve the ends of equity and economic neutrality, by providing an ad hoc substitute for the indexing of the basis of depreciable assets for inflation, a solution that is known to be extremely complicated.[78] Many also favor the increased incentives for capital formation that are produced by accelerated depreciation.

The potential problems of accelerated depreciation are formidable. First, depending on the rate of inflation, the use of accelerated depreciation may cause income generated by depreciable assets to be understated and thus may violate horizontal equity and--given the inequality in the distribution of ownership of capital--vertical equity. According to this line of reasoning, the combination of economic depreciation and explicit indexation of basis is far superior.[79]

Second, even if it can be argued that the benefits of accelerated depreciation are passed on to customers, the perception of equity is damaged when wealthy individuals and powerful corporations pay little or no tax because of the use of excessive depreciation allowances to offset otherwise taxable income. Further damage to the perception of equity, if not equity itself, occurs if taxpayers who do not have income enough to fully utilize accelerated depreciation allowances are allowed to sell them to other taxpayers, as occurred under "safe-harbor leasing."

Damage to the perception of equity is particularly unfortunate, since it undermines taxpayer morale, which is essential to the operation of a system based on self-assessment.[80] The availability of high-visibility tax shelters may undermine compliance by those who do not make the distinction between legal shelters and illegal evasion.[81] (This might be dubbed the "cocktail party problem," referring to the fact that it can hardly be good for taxpayer morale to hear at a cocktail party how someone else is avoiding taxes.)

In this sense tax expenditures are quite different from budgetary expenditures. If the government spends public funds in ways that taxpayers find inappropriate, there may be a sense of disapproval and frustration, but there is not likely to be a feeling that the <u>tax system</u> is unfair. If, however, the government uses tax expenditures to "fund" programs--even programs that are agreed to be in the general interest and, <u>a fortiori</u>, those known to be in the narrow interest of the taxpayers who benefit from them--there is likely to be a feeling that the tax system itself is unfair.

Much the same can be said about the complexity created by tax expenditures. Direct expenditures intended to achieve the same results would also presumably be complicated. But such complications would not affect the complexity of the Code.

If popular discontent with the perception of inequity becomes great enough, the unpopular provision may be repealed outright, as occurred with safe-harbor leasing. Even if that does not happen, the Congress may classify the provision as a tax preference subject to the AMT. When TRA '86 extended the AMT to corporations, one of the biggest preferences caught in its net was the excess of accelerated depreciation over either forty-year straight-line depreciation (real property) or 150-percent declining balance depreciation based on ADR lives (personal property).

Third, to the extent that accelerated depreciation is more generous than (indexed) economic depreciation, tax considerations artificially distort business decisions in favor of tax-preferred investments. In extreme cases, the marginal effective tax rate applied to earnings from certain investments will actually be negative, implying that the after-tax return exceeds the before-tax return.[82] Public policy that produces this result is, of course, highly suspect, since it is likely to involve the waste of scarce resources.[83] The use of the AMT to limit access to the benefits of accelerated depreciation implies that the tax system may not be neutral in its impact on otherwise similarly situated taxpayers, one of whom is subject to the AMT and the other is not.

Finally, the apparent ease of compliance with a system such as ACRS hides complexities that may not be obvious to the uninitiated. Complexity occurs as more and more deals are structured to take maximum advantage of the preferential treatment of depreciable assets and the government acts to prevent abuse or the appearance of abuse. For example, recapture rules may be necessary to prevent taxpayers from paying only preferential capital gains taxes on amounts that have previously been deducted at an accelerated rate. The AMT was devised for the explicit purpose of preventing taxpayers from using tax preferences such as accelerated depreciation to avoid taxation altogether; in response to perceived abuses TRA '86 Act extends the AMT to corporations and--in perhaps the zaniest provision of all--bases it on book income, which is not even a Code concept. In essence, the AMT is a parallel tax system. In the words of one of the large accounting firms, "The AMT imposes heavy burdens on taxpayers in the form of complexity, adverse economic effect, loss of incentives, and added record keeping. . . .[I]t is clear that the hair-pulling complexity of the calculation will be both costly and time-consuming."[84] The other complex anti-shelter rules of TRA '86 (including the passive loss rules, expanded at-risk rules, and the limitations on interest deductions) are also designed to prevent the excessive use of various provisions, singly or in combination, to avoid taxes.

Complexity for Whom?

In discussing complexity it is useful to distinguish between two groups.[85] The first consists of individuals of modest means who have relatively uncomplicated financial affairs. For them itemized deductions probably constitute the primary source of complexity, although Schenk argues convincingly that there is still much unnecessary complexity, especially for those least able to cope with it.[86]

For this group the tax system is probably not more complicated on average than in 1980, and it may be less complicated once one considers transactional complexity, rather

than focusing only on rules and compliance complexity. The increase in personal exemptions and standard deductions has removed many from the tax rolls, the 2-percent floor on miscellaneous deductions reduces the need to keep track of minor expenses that would otherwise be deductible, limitations on the availability of IRAs reduce the need to be concerned with IRAs and the provisions affecting them, and the virtual elimination of tax shelters removes this source of transactional complexity for the few who might otherwise be involved in them. Perhaps most important among the primary counter-forces adding to complexity is the limitation on mortgage interest deductions (discussed in the next section).[87]

The second group is relatively heterogenous, including individuals in business for themselves, other individuals with complicated financial situations, and corporations. For many of these the system is probably more complicated on balance than in 1980, even considering gains in transactional simplicity.[88] These groups are likely to be affected by many of the sources of complexity identified in the previous part of this section: income definition questions (especially timing issues and questions of dual business-personal use), subsidies provided through tax expenditures, backstop rules intended to limit the availability of tax benefits, transition issues, and the general incoherence of the system as it affects the taxation of income from business and capital. An especially important source of increased complexity for this group is the increased sophistication of financial markets and the instruments they produce; this complexity is multiplied when one gets into the international arena, as many large and medium-sized firms must. Some of the most important sources of complexity for this group are discussed in the next section.

COMPLEXITY IN RECENT LAW

Much has been made of the complexity of TRA '86. This author has written, for example, "[I]t is horribly complex--so much so that we may have shown definitively that attempting to implement a conceptually correct income tax (even one without inflation adjustment) is impractical."[89] Yet we should not lose sight of the fact that TRA '86 Act did simplify the tax system for many--especially by removing low-income individuals from the tax rolls--and that the increased complexity is experienced primarily by relatively few high-income or wealthy individuals with complicated financial situations, by many small businesses, and by corporations. Having said this, it will be useful to examine several of the most complex features of recent legislation to attempt to classify them into the various categories just described. Thus we consider the impact of these rules on three types of complexity--rules, compliance, and transactions--as well as their probable overall impact. We then consider the source of the complexity: income definition, tax expenditure, backstop, transition, and incoherence. In several instances, one provision may have characteristics of several categories. Finally, we may note at the outset that, with the exception of some of the interest provisions, it is almost entirely relatively affluent individuals and corporations who experience the complexity of the provisions examined.

Nondiscrimination Rules

TRA '86 Act continues the prior practice of using so-called nondiscrimination rules to assure that the benefits of employee benefits are not reaped only by upper management and other highly compensated employees. These are among the most complex provisions of TRA '86 Act outside the international arena--so much so that it appears as this is being written that section 89 may be on the verge of repeal. These provisions are particularly maddening for small businesses. While some transactions complexity may be avoided because of the complication of rules and compliance, on balance these rules seem to complicate the system.

The underlying tax treatment of the various employee benefits to which nondiscrimination rules are applied can be traced to a combination of a failure to define income adequately (failure to realize that, as an economic matter, fringe benefits should be included in income for tax purposes) and a conscious effort to encourage the provision of such benefits. Moreover, there may be more than a little bit of incoherence in the rules.[90]

The trouble with the tax expenditure approach to policy-making in this instance is that while the provision of benefits to the rank and file may have justified enactment of the initial tax expenditure, upper-income employees have typically been the primary ones to benefit from the provisions. Nondiscrimination rules have been used to further the original intent of the Congress and to limit the benefits if such intent is not achieved. Thus it appears that the explanation of the complexity of these rules may have an element of at least four categories: income definition problems, tax expenditure objectives, backstopping, and incoherence.

Anti-shelter Provisions

Over the years the Congress has adopted increasingly stringent rules intended to limit the opportunities to use excessive deductions to shelter income from tax. These include at-risk rules, the AMT, the limitation on passive losses, and the limitations on interest deductions, all of which were either newly enacted (corporate AMT and passive loss rules) or tightened (at-risk rules, individual AMT, and interest limitations). Both the rules in question and compliance with them are complicated. On the other hand, by essentially killing tax shelters, these rules greatly simplify transactions. To the extent this occurs, the rules make a net contribution to simplicity.[91]

These rules seem to fall almost entirely within the "backstop" category. Some are needed because of the opportunities for arbitrage created by the juxtaposition of rules based on accrual and on realization. They are not needed for income definition or for the provision of tax expenditures. (Indeed, they are generally the result of congressional reaction to perception problems stemming from faulty income definitions traceable to tax expenditures.)

It appears that in TRA '86 the Congress may have actually engaged in "overkill," in the sense of using redundant provisions to attack tax shelters.[92] In some cases, the rules have

a retroactive effect that is inconsistent with at least some definitions of appropriate transition rules.[93] This may not have been unintentional; it may have been done as much to extract revenue from holders of existing shelters as anything. Such a decision was almost certainly driven largely by the demands of revenue neutrality; here was a source of badly needed revenue that could be hit hard without evoking sympathy from the general public.

While one must welcome the curtailment of tax shelters, one must pause at the way chosen to achieve this objective. It is useful to distinguish between what might be called "regular" tax shelters and "abusive" tax shelters.[94] Regular shelters are based primarily on tax benefits that are clearly legal; they are subject to attack primarily because of their adverse effects on equity, efficiency of resource allocation, and perception of equity. By comparison, abusive shelters involve the use of techniques that are questionable, if not clearly illegal, to shelter income beyond what would reasonably be expected from a reading of the tax law; essentially, they involve fraud and tax evasion.

The at-risk rules were primarily an attack on abusive shelters involving overvalued property and nonrecourse debt; they would have relatively little effect on regular shelters. On the other hand, the passive activity limitations hit all shelters and were intended virtually to eliminate them. As Koppelman notes, the limitation on artificial losses operates in a much more satisfactory manner to reduce sheltering.[95]

While everyone agrees that abusive shelters should be ended, opinion is divided on the benefits of eliminating regular shelters. (It should be clear from the previous discussion that I am generally in the antishelter camp.) The limitations on passive activities have the effect of denying current deductions for legitimate costs under certain circumstances. By so doing they inject a schedular element into an ostensibly global income tax. In this way the budget-driven process of tax reform has introduced into the U.S. income tax an element that does not belong there--one that is generally decried as "backward" by tax advisers who encounter schedular income taxes in developing countries.

Interest Deductions

TRA '86 contains distinctions that produce more than a half-dozen identifiable types of interest expense, each with its own tax treatment. Sunley identifies the following: investment interest, passive loss interest, nondeductible personal interest, interest to carry tax-exempts, construction period interest, home mortgage interest, and active business interest. There are undoubtedly others.[96] Interest expense incurred in the active pursuit of a trade or business is fully deductible, as is mortgage interest paid to finance the purchase or improvement of most owner-occupied housing. On the other hand, "investment interest" is subject to limitations, to prevent the deduction of interest expenses incurred to finance investments yielding tax preferred income, including deferred income. In one sense this rule is an extension of the old (1921) rule that forbids the deduction of interest expense incurred to carry state and local securities paying tax-exempt interest. Nor is interest incurred on unsecured personal debt deductible, even if used for the purchase of the residence of the taxpayer.[97] To make matters worse, even interest on mortgage debt is not deductible to the extent the indebtedness exceeds the sum of the original purchase

price of the house, plus improvements, except to the extent it is used to finance expenses of health care and education. Construction-period interest must be capitalized rather than deducted currently. Passive loss interest must be traced in order to comply with the limitations on passive losses.

The fungibility of money implies that any time a taxpayer has more than one kind of debt outstanding it is impossible to determine logically which debt is used for which purpose. Over the years various categories of debt have been subjected to different rules limiting deductibility, as the need to prevent abuse has become apparent. Thus it is not surprising that so many different rules specifying the determination of the split of the taxpayer's total interest expense among different "baskets" have been enacted, without due regard to the coherence of the various rules. For example, construction-period interest is determined on a "stack first" basis. Interest incurred to carry tax-exempt securities is determined under an imprecise set of rules based in part on the taxpayer's purpose. The portions of interest held to be investment interest, passive loss interest, and personal interest are determined under IRS regulations by using a tracing approach.

Doernberg and McChesney have commented on this situation in the following terms:

> Essentially the proposed regulations require taxpayers to trace how they use a loan from the day they take it out until the day it is repaid. For example, suppose a taxpayer borrows $10,000 and puts it in an interest-bearing checking account. During the year the taxpayer buys a car, purchases stock, invests in real estate, and expands his business, the single loan has generated four different types of interest, each subject to its own limitations. Moreover, to the extent the borrowed funds are commingled with nonborrowed funds, the IRS has provided elaborate rules for tracing which money is used to make which purchase.[98]

These rules increase both rules complexity and compliance complexity. Except for the case of tax shelters, already discussed, it seems unlikely that there will be great offsetting gains in transactions simplicity.

This mishmash of rules can be explained by a number of motivations. First, the deduction for home mortgage interest is one of the most venerable and impregnable of all tax expenditures.[99] The nondeductibility of other personal interest (commonly called consumer interest) can be seen as an attempt not to extend that tax expenditure to such interest; unfortunately, in the case of home equity loans a drawing of the line becomes necessary to prevent sophisticated taxpayers with equity in their homes from circumventing the intent of this provision, and the confusion is compounded by the tax-expenditure exception for home equity loans for the finance of spending on health care and education. The limitation on deductions for investment interest, like the nondeductibility of interest incurred to carry tax-exempt securities, can, as noted previously, be explained as a backstop attempt to prevent taxpayers from abusing overly generous provisions in other parts of the Code.

Kiddie Tax

Few would argue that all the non-labor income of minor children should be taxed at the marginal rate of the parent(s). Nor would many argue that it should be possible to avoid the effects of progressive taxation by having non-labor income properly attributable to the parent(s) taxed in the hands of minor children. The purpose of the "kiddie tax" provisions of the 1986 Act is to achieve a reasonable compromise in which the worst abuse is prevented, without causing either undue complexity or undesirable tax burdens on the legitimate non-labor income of children.[100] Thus this provision is properly placed in the "income measurement" category.

The kiddie tax is a good example of a provision that, considered by itself, is complicated in the rules and compliance sense for those affected by it. But it is not likely to affect many who are not using tax planning to minimize taxes. Thus it is also a provision whose effects can easily be avoided by most taxpayers; in this sense the provision may reduce complexity on balance, by reducing transaction complexity. Its complexity is likely to pose serious problems only for wealthy families whose minor children have been accorded ownership of substantial wealth for non-tax reasons.[101]

Capital Gains

Capital gains has recently been a virtual battlefield between those who want more and less generous treatment of gains.[102] Some of the changes that have been made, and others that have been talked about, illustrate possibilities for increasing or decreasing complication in this area. It might be worth noting at the outset that one of the primary reasons for the taxation of real capital gains like ordinary income--aside from the equity and neutrality arguments for such an even-handed policy--is the elimination of the rules and transactions complexity that results from allowing preferential treatment of long-term capital gains.[103]

In 1976 the Congress passed "carryover basis" for assets transferred at death; the rationale was some combination of income measurement and backstopping (by avoiding postponement of tax during lifetime being converted to immediate forgiveness of tax via step-up of basis at death). This would not appear, at first sight, to be complicated; the recipient of property transferred through bequests would simply take the basis of the transferor in calculating future gains. The trouble comes in knowing what the transferor's basis is. By comparison, under present law (and law at that time), step-up of basis at death obviates the need to know the transferor's basis. In framing its 1984 tax reform proposals to President Reagan, the Treasury Department considered, but rejected, the introduction of "constructive realization" at death, a less generous approach to the same problem.[104]

Treasury I proposed that the basis of assets be indexed for inflation, in order to prevent the taxation of fictitious gains; indexation is an income measurement technique that has recently been championed as a more rational alternative to a return to a preferential rate (or partial exclusion) for long-term gains. Indexation is inevitably complicated, not so much because of the mechanics of indexation, which could be handled through tables of

escalation factors based on time of acquisition, as because of the transitional difficulties of shifting from an unindexed system to an indexed one. It would be necessary to value all assets on a particular day in order that indexation take effect only from that day on.[105]

The 1986 Act eliminated the preferential taxation of capital gains (except for the benefits of deferral), but without providing indexing. It is thus questionable on income-measurement grounds. It eliminates incentives to structure or characterize transactions in such a way as to achieve capital gains taxation. In this way it contributes to transactions simplicity, as well as to rules-and-compliance simplicity.

Recent days have seen a plethora of proposals for the reduction of taxes on long-term capital gains. Among the candidates have been President Bush's proposal to cut the rate of tax on gains to 15 percent, with an optional 45 percent exclusion; Representative Ed Jenkins' plan to cut the rate to 19.6 percent for two years and them switch to indexation; a more complicated scheme favored by Ways and Means Committee Chairman Rostenkowski that would provide only indexation for gains on assets held between one and five years, but would offer the choice between indexation and partial exclusion for gains on assets held longer than five years; and a plan supported by Senators Bob Packwood and William Roth for an exclusion that increases (by five percentage points per year, to a maximum of 35 percent) with the length of time assets have been held. (The Packwood-Roth allows indexing as an option. It also contains the "back-loaded IRA" mentioned earlier, which they call "IRA-Plus.")

The Jenkins proposal offers a glaring example of the fiscal craziness that current budget rules encourage. The two-year reduction in the rate would encourage realizations during the "window" of low rates, and therefore help solve the short-run budget problem; but it would do so by borrowing revenues from the future--and leaving future budget difficulties. Being almost entirely a windfall, it would not have the benefits commonly said to result from (permanent) preferential treatment of long-term capital gains.

Moreover, the restoration of a preferential rate for capital gains would give rise to transaction complexity, as well as rules-and-compliance complexity. One of the constant themes of the recent AICPA/ABA conference on simplification was that restoration of a capital gains preference would add greatly to complexity.[106]

Repeal of General Utilities

Handler offers the repeal of General Utilities as an example of how the Tax Code has been complicated by the requirement of revenue neutrality, because of the failure to consider collateral effects. In 1982 the American Law Institute proposed that General Utilities be repealed, but only "in the context of an entire structure for the acquisition, reorganization, and distribution provisions of subchapter C." Following hearings and several years of further work by an ad hoc group, the staff of the Senate Finance Committee issued a report and proposed the revision of subchapter C. Although Handler calls this proposal "by no means perfect or uncontroversial," he asserts that "it was a comprehensive piece of legislation accompanied by a thorough report." By comparison, he argues, the 1986 Act

"contained virtually none of its features dealing with acquisitions and distributions . . . . The repeal of General Utilities was selected solely as a means of closing a revenue gap . . . . Thus this one provision was selected from the entire Subchapter C Revision Act as a revenue measure unrelated to comprehensive tax reform."[107]

Handler goes on to identify the following problems with this outcome: The repeal of General Utilities precluded any meaningful discussion of integration of the corporate and individual income taxes; it foreclosed discussion of other aspects of the reform of subchapter C; the Congress passed up the chance to repeal or revise complex statutes that are no longer relevant and to correct a number of basic inconsistencies that have been aggravated by the repeal of General Utilities.

Handler's views on the repeal of General Utilities seem to be somewhat extreme; certainly they are not shared by many who have commented on an earlier draft of this paper. In particular, some would deny that it was inappropriate to separate the repeal of General Utilities from other reforms of subchapter C; some view repeal as a viable stand-alone option.[108] Handler's views seem especially suspect as they relate to the possibility of integrating the income taxes. First, relief from double taxation of dividends was considered in the same bill as repeal of General Utilities; it simply was not adopted. Second, repeal of General Utilities had a very small effect on revenue; it thus may not be correct to suggest that it was primarily a revenue-raising provision. Finally, rather than dooming all attempts at integration, the repeal of General Utilities--by making it difficult to achieve "do-it-yourself integration"--may actually be the first step in a political process that will lead eventually to integration (or to "dividend relief").[109]

Penalty Provisions

Beginning with TEFRA, penalty provisions, including rules governing interest on late payments, have been tightened significantly.[110] Given the growth in tax shelters, the rise of willingness to play the "audit lottery," and the inflation-driven increase in interest rates during the late 1970s and early 1980s, this development was appropriate, at least in a general sense. But it appears that in the process of making penalties and interest rules tighter, not enough attention has been devoted to rationalizing penalties. Thus layers of penalties are piled upon each other, producing a system that is complicated as well as arguably unfair. It appears that at least part of the political attraction of introducing tougher and tougher penalties is the possibility of raising money from a segment of the population that is relatively unlikely to receive much sympathy, without explicitly raising taxes.

International Provisions

The provisions dealing with the taxation of international business are among the most complicated of those in the 1986 Act. These include the provisions for the tracing and allocation of income and deductions for purposes of both the determination of the geographical source of income and the availability of foreign tax credits. This complication

is the inevitable result of the attempt to relate foreign tax credits to the foreign income that produced them, in order to prevent taxes paid on foreign-source income from being used to offset tax on domestic-source income. This failure, in turn, can be traced to the lack of a coherent international system for the taxation of the income of multinational corporations. Since the present international tax order allows one nation to be played off against another, each must have complicated rules to protect its fiscal interests.[111] The rules for foreign currency transactions and foreign sales corporations are extremely complex.

INTO THE SUNLIGHT--AND BACK

Tax policy does not just happen. It is the result of deliberations by the tax-writing committees, of the House and Senate acting independently on the reports of those committees, and of the conference committees which iron out differences between House and Senate versions of legislation. It is important to understand how these institutions operate if one is to understand how budgetary constraints affect the relative simplicity of tax legislation.

Before the "good-government" reforms of the 1970s brought Congressional decision making into the sunlight, legislation on tax policy was written almost entirely by the House Ways and Means Committee, largely behind closed doors in an environment that served to insulate policymakers from the pressures of special interests; it was then considered under rules that limited the opportunity for making changes on the floor of the House.[112] While the Senate, including its Finance Committee, operated under much more laissez-faire rules that facilitated the introduction and passage of extraneous tax preferences, the House, via the conference process, generally acted as an effective brake on Senatorial irresponsibility. The result was that changes in tax policy generally were made with greater deliberation and more careful consideration of their likely economic effects than has been the case in recent years.

Congressional reforms brought policymaking much more into the open, with results that are mixed, at best. Passage of the fundamental tax reforms of 1986 seem to have been possible only because ways were found to retreat from the watchful eyes of lobbyists. This section describes the history of these reforms and counter-reforms.[113] Those familiar with this history may wish to skip this section.

The Pre-reform Process

The following characteristics of tax legislative process in the pre-reform era have been identified:

- The Ways and Means Committee was small (25 members) and congenial, operating without committees under a chairman chosen on the basis of seniority.

- Members of the Committee were carefully chosen to be party regulars from safe districts.

- Tax legislation was written in executive sessions, away from the scrutiny of lobbyists. It was then considered under a closed rule that precluded amendment of particular provisions on the floor of the House.

- The constitutional assignment of power to initiate tax legislation to the House of Representatives was carefully respected. This furthered the Chairman's ability to control the agenda of tax legislation.

- The role of the Ways and Means Committee as the Committee on Committees gave it the power to exercise power and discipline over potentially recalcitrant non-members of the Committee, especially those seeking assignments to choice committees.

- "Members' bills" were used to respond to the most pressing needs of constituents.

As a result of these features, "The tax policy process in the House was not very democratic, but it was skillfully controlled."[114] Moreover, it was "stable and predictable."

Particularly important was the relative isolation of members of the Committee from lobbyists and other representatives of special interests. "Because there were no public records of their positions, committee members were free to take responsible positions on issues without openly rejecting the demands of lobbyists or openly taking unpopular positions . . . ."[115] This stands in marked contrast to the picture we get from popular descriptions of procedure under the good-government reforms to be described below.[116]

The Senate has traditionally operated under a very different set of rules that invited irresponsibility--irresponsibility that, if unrestrained, would raise too little revenue and produce a tax law that would be unfair, non-neutral, and overly complex.[117] The primary culprit was the Senate rule that tax bills be considered under an "open" rule; it invited turning bills into "Christmas trees."[118] McDaniel has noted, "The Senate 'open' rule is a prescription for a tax statute that is unnecessarily complex, however complexity is defined."[119] A common pattern developed, in which the most egregious provisions of the Senate bill were eliminated in the House-Senate conference, often with the tacit approval of the grandstanding senators who had sponsored them on the Senate floor.

Policymaking in the Sunlight[120]

The congressional reforms of the 1970s weakened the constraints that made the tax policy process stable and predictable, if not democratic. The membership of the Ways and Means Committee was expanded to thirty-seven. Committee chairmen are selected by

secret ballot, instead of by seniority. The Committee now operates with subcommittees. The proceedings of the Ways and Means Committee and of the House-Senate Conference Committee have been opened, except when closed by majority roll call vote. The closed rule has been modified to allow amendments on the floor of the House. Committee assignments of Democrats are now made by the Democratic Steering and Policy Committee, rather than by Ways and Means. Members from unsafe districts have routinely been assigned to the Ways and Means Committee. The procedures established by the 1974 Budget Act serve both to weaken further the chairmen of the tax committees and to strengthen the budget committees.

Contrary to the expectations of the advocates of good government reforms, enacting tax legislation in the sunlight has not proven to be a success. Stanley Surrey has observed:

> The consideration of tax legislation by the Congress has completely disintegrated. The picture has been one of almost utter chaos, without responsible control residing anywhere. Tax legislation has become a catch-as-catch-can affair that produces complexities, unfairness, conflicting moves in all directions, almost mindless provisions....[121]

Another commentator has written the following equally pessimistic assessment:

> The requirements for making responsible tax policy seem to run counter to open, decentralized legislative procedures, especially when organizing forces, such as strong political parties, that can facilitate cohesion are lacking.... The congressional reforms of the 1970s have led to a loss of internal leadership, heightened individualism, increased responsiveness to organized interests, and erosion of the autonomy of Ways and Means. Although the reforms were in accord with democratic precepts, the verdict on their effect on the capacity of Congress to do its job has been distinctly negative.[122]

Several results of these changes have been identified. First, ad-hoc decision making has replaced deliberate consideration of proposed changes in the tax law. Second, traditional legislative procedures have been bypassed. For example, amendments affecting tax law have been added to legislation on the floor of the House, and House resistance to Senate provisions in conference has been weakened.[123] Third, at least prior to the 1986 Act, the tax system has come increasingly to be used for non-tax purposes.[124] Fourth, the course of tax policy has become extremely erratic since the passage of the good-government reforms. Tax reform occurred in 1976, but was reversed in 1978; in 1981 ERTA drastically reduced taxes and provided generous investment incentives, but TEFRA and DEFRA, passed in 1982 and 1984, respectively, took back many of the benefits of the 1981 legislation and increased taxes substantially; finally, TRA '86 made fundamental changes in the system, among the most important of which was the virtual elimination of the 1981 investment incentives.[125] (In addition, repeal of one of the most fundamental features of the 1986 Act, the taxation of long-term capital gains as ordinary income, is being actively discussed as this is being written.) Of course, it can be questioned whether this pattern is explained wholly--or even primarily--by the good-government reforms.

Reese has noted that the advent of open sessions also changed the availability and nature of advice given the tax-writing committees.[126] First, it reduced somewhat the influence of the Treasury Department and the staff of the Joint Committee on Taxation, who could participate much more actively in closed sessions than in open ones.[127] Second, it increased the influence of the personal aides of members, who could attend open sessions, but not closed ones. Because of this and the easier access to lobbyists, Reese ventures, "In general, I would guess that opening the markups has been a plus for democracy but a minus for tax reform."[128]

The 1981 and 1982 Acts

The failure of the new system to produce responsible legislation is seen perhaps most clearly in the 1981 Tax Act. The bill that became ERTA began in the Senate, contrary to legislative tradition, if not constitutional requirements, and it received no careful consideration by the Ways and Means Committee. It became the subject of a bidding war, as House Democrats and the Reagan administration vied to see which could be more generous in the tax cuts they proposed.[129] Rudder has written, "Absent were careful deliberation, a sense of limits, an ability to say no to claimants, and an overriding concern for the quality of the bill and for the integrity of the tax code.[130]

This fiasco cannot be attributed entirely to the openness of the new legislative process; it appears that partisan competition was the main culprit. Yet it seems unlikely that this competition could have occurred or reached its 1981 levels under the pre-reform rules.[131]

Disarray in the Ways and Means Committee continued in 1982. Rather than preparing its own tax bill for passage by the full House, the Committee simply went to conference with the Senate without even having considered a bill. Three things about the ultimate result are extremely interesting.[132] First, the procedures used by Bob Dole, chairman of the Senate Finance Committee, to produce a tax bill ran directly counter to the spirit of the Congressional reforms that had rendered the Ways and Means Committee impotent, as well as to traditional Senate procedures. (Dole's initiation of action also ran counter to tradition, based on constitutional requirement, that revenue bills begin in the House.) He excluded the public, the press, and even Democratic members of his committee from the meetings in which the tax reform package was put together. Then he employed a germaneness rule to limit floor amendments in the Senate.[133] In short, he achieved substantial closing of loopholes, as well as raising a large amount of revenue, by stepping around the good-government rules. One observer has suggested that "the reversal of the spirit of the open-meetings reform that extended to most congressional deliberations may have been indispensable in producing legislation."[134]

Second is the role played by the 1974 Budget Act. Congress, acting under that legislation, specified the revenue target and set the deadline for action. Moreover, the Budget Act provided the germaneness rule that allowed Dole to fend off floor amendments.

Third, as things actually transpired, tax reform may have been furthered by the lack of a House bill. Lacking instructions from the House, Chairman Rostenkowski of the Ways

and Means Committee had a relatively free hand to negotiate with the Senate conferees. Rather than acting in their traditional restraining role on an overly generous and irresponsible Senate, the House conferees simply accepted many tough provisions that had been placed in the Senate bill with the expectation that they would be softened or eliminated in conference.[135] Despite this practical success, one observer has concluded that:

> The tax bills of 1981 and 1982 give credence to the assessment that the congressional reforms failed. The decentralization and democratization of Congress, and of the House in particular, seem to have left the legislative branch in a state of semianarchy and capable of acting responsibly on taxes only by circumvention of normal procedures, such as reverting to secret sessions, and only in response to severe economic crisis.[136]

Witte has reached the following similar conclusion:

> Political reforms have often been called in the name of openness and "sunshine." However, . . . window shades and moonlight may be the more appropriate prescription. Opening the process allows claimants an additional forum, and, even legislators inclined to duck such pressure will have fewer places to hide. . . . While the theory was that open meetings and recorded committee votes would expose those conferring special favors, it seems more plausible that these "reforms" result in an inability of legislators to not confer such favors.[137]

Back into the Shadows

The period since 1981 has seen a de facto retreat from some of the sunlight of the good-government procedures created by Congressional reform into the shadows of prior practice, producing a return to more fiscally responsible decision making in tax policy. This was especially true of the passage of TRA '86.

The shift in legislative techniques used by Dole in 1982 presaged changes to be made on the House side, both in the abortive 1983 attempt at deficit reduction and the 1984 passage of DEFRA. Such changes included the use of closed markup sessions to insulate committee members from outside pressures, the use of Democratic caucuses in the committee to develop partisan support, molding legislation to meet the concerns of Democratic committee members, using "sweeteners" to gain the support of other members of the House, and consideration of legislation on the floor of the House under a closed rule.[138]

In the process leading up to TRA '86 these techniques were used by Rostenkowski in dealing with the House Ways and Means Committee and (in general, if not in detail) eventually by Senator Bob Packwood, the chairman of the Senate Finance Committee (after an initial business-as-usual effort that lost $30 billion in revenue and threatened to kill tax reform).[139] Weekend retreats were used to gain the undivided attention of

committee members.[140] The Ways and Means Committee was divided into working groups that were given revenue targets.

Insulation from lobbyists was carried to unusual lengths in the House-Senate conference; after the first two days of open meetings, the conferees did not meet publicly until the last night of the conference, three weeks later, by which time the die had been cast. In the face of a potential impasse, the two committee chairmen were simply empowered to work out compromises to be ratified later by the full conference committees.[141] Witte notes, "One of the undeniable hallmarks of this legislation was a retreat to a more closed and controlled process that had been lost in tax politics for over a decade."[142]

Packwood has defended this procedure in the following terms:

> Common Cause simply has everything upside down when they advocate "sunshine laws." . . . When we're in the sunshine, as soon as we vote, every trade association in the country gets out their mailgrams and their phone calls in twelve hours, and complains about the members' votes. But when we're in the back room, the senators can vote their conscience. They vote for what they think is good for the country. Then they go out to the lobbyists and say, "God, I fought for you. I did everything I could. But Packwood just wouldn't give in, you know. It's so damn horrible.[143]

Rostenkowski has echoed essentially the same sentiments: "I've heard some [committee members] say--not all--that I give them cover so they don't have to compromise with the pressure groups on the outside--blaming the chairman."[144]

An additional important element was the rule of revenue neutrality, under which any proposal for a tax benefit had to be accompanied by a proposal for a method of paying for it. This rule had first been reluctantly accepted by the Senate Finance Committee. The out-of-character Senate agreement to abide by this constraint on the floor made it much more difficult to gain agreement to insert new benefits into the bill.[145]

One of the most popular means of providing sweeteners in the 1986 legislation was through the use of so-called transition rules."[146] Targeted transition rules were used on an unprecedented scale in moving the 1986 legislation through the tax-writing committees and then the two houses of Congress. In comparing the 1986 experience with historical practice, Boris Bittker has said, "The scale of these precedents bears about the same relationship to the exemptions of the 1986 Act that a child's lemonade stand bears to a regional shopping mall."[147]

This has been the source of great inequity, as transitional rules have been applied to quite narrowly targeted situations (sometimes involving only one influential taxpayer) chosen to gain the support of key members of Congress and described in the statute carefully enough to prevent their general applicability. Birnbaum and Murray note:

> In past years, transition rules were included in the bill for the benefit of special constituents, but were drafted in ways that would also aid others who were similarly situated. The tax-reform rules, however, were frequently written like rifle shots to benefit only the constituent companies or individuals--and no one else. That meant that two companies or people with exactly the same tax situation could well be treated very differently under the bill.[148]

Moreover, often they are not transitional in any meaningful sense of the term; they are permanent tax breaks masquerading under the guise of transition rules.

PROCESS AND COMPLEXITY

There is little doubt that the budgetary process has had an adverse effect on the attempt to simplify the U.S. income tax. Simon has noted, "The impact of the current budget reduction law, Gramm-Rudman-Hollings (GRH), on the tax policy process has been quite severe. Numerous examples of revenue concerns having outweighed policy concerns in recent years provide anecdotal evidence that supports the notion that balanced-budget rules--when they work--frequently result in bad policy choices."[149]

In much discussion of the topic of this paper, there is an unfortunate tendency to confuse two conceptually separate ideas: revenue neutrality and policymaking "under the gun" of reconciliation. Thus, for example, Handler connects the two quite explicitly:

> It now has become commonplace for the budget reconciliation process to involve substantive revision of the Internal Revenue Code solely for the purpose of raising revenue. TEFRA, DEFRA, and the 1987 Omnibus Budget Reconciliation Bill involved major efforts at raising revenues almost exclusively by means of substantive tax revisions. Even the Tax Reform Act of 1986, one of the most comprehensive tax reform measures ever adopted, followed a similar process since it was adopted under strict principles of "revenue neutrality" as mandated by the companion Budget Reconciliation Bill. This required numerous instances of "reform" measures to be adopted to close revenue gaps.[150]

Since the two can be separated, it is useful to do so.

Policymaking "Under the Gun"

There seems to be substantial agreement that reforming the tax system under the pressure of reconciliation is much more likely to lead to complexity than to simplicity. This is true, in part, because the process simply does not lend itself to orderly and deliberate consideration--by the staff and the public as well as by the Congress--of various proposals and how they interact with each other. The reconciliation process allows only two months

between the adoption of the instructions to the tax-writing committees in April and the due date for the revenue bill in June.

Handler provides the following contrast of policy making before and after the 1974 Budget Act and reconciliation:

> This is a dramatic departure from prior tax legislation. Throughout the twenty-six years, from 1954 to 1980, many pieces of major tax legislation were adopted. These bills were refined, to some extent, by the appropriate legislative processes--bills were first introduced in the House, hearings and testimony were solicited, draft legislation was circulated for comment, and meaningful debate occurred on the House floor, all prior to adoption of the legislation. The process was repeated in the Senate, and was usually followed by a conference at which the differences between the House and Senate bills were compromised.[151]
>
> Budget reconciliation has clearly changed this tax legislation process. It is now common for both Houses of Congress to consider simultaneously two materially different substantive tax revision measures, disguised as "revenue enhancement." This substantive reform is conducted without hearing or reports, frequently is conducted in secret, often is adopted as a conceptual matter with the drafting done later, and is usually passed on the floor of both houses without permitting amendments or serious debate.[152]

Former Assistant Treasury Secretary John Nolan has described the problem as follows: "[T]he real problem here is that we have departed from an orderly and predictable process for identifying the legislative issues in advance and dealing with them in some well-organized way through the process."[153] Handler has noted:

> There can be little question that substantive tax revision solely for revenue-raising purposes is not a sensible reform process . . . . [T]he Internal Revenue Code is an incredibly complex document dealing with vast areas that require considerable correlation and coordination. It is virtually impossible to imagine that any kind of sensible tax reform can be effected in a helter-skelter fashion under circumstances where the only rationale for developing any reform is the revenue-raising function of the budget reconciliation process."[154]

The following have been identified as defects of revenue-driven tax legislation: "constant churning of the Tax Code, voluminous technical corrections bills, sizeable regulations-projects backlogs, and growing administration and compliance costs." A few data provide an indication of the magnitude of the problem. The technical corrections of the 1984 and 1986 Acts required roughly one fourth as many pages (24.9 and 27.7 percent, respectively) as the acts they were correcting; by comparison, the comparable figures for the 1976 and 1982 Acts were just over 11 percent. As of April 30, 1989, there were 510 uncompleted regulations projects at the IRS.[155]

The Discipline of Revenue Neutrality

Revenue neutrality has obvious advantages, aside from any salutary effect of restraining the growth of the deficit; most notably, it forces the Congress to consider trade-offs between various tax expenditures and to think about the cost of government spending. Thus, Strahan notes, ". . .Ways and Means Committee decisionmaking on tax issues has shown very limited responsiveness to clientele interests since the appearance of large deficits in 1982. . . . Responsiveness to clientele interests seeking to maintain tax preferences was strictly constrained by the political imperative to at least maintain the existing revenue base."[156]

The desirable discipline imposed by revenue neutrality has, however, become somewhat of a Frankenstein that sometimes leads to questionable changes and sometimes precludes desirable ones. Rob Leonard, chief of staff of the House Ways and Means Committee, wrote in early 1988, "The most significant obstacle to prompt enactment of the technical corrections bill remains the obligation to offset any revenue loss associated with the bill--a task made more difficult by the determination of some to include costly extensions of expiring provisions."[157] Further, commenting on how budgetary pressures for additional revenues encourages continual "reform," Leonard has written, "Unless and until those deficits are reduced to more acceptable levels, many budget analysts, economists, and politicians will propose a 'revenue component' to any deficit-reduction package with all the destabilizing effects and turmoil that attends the budget reconciliation process."[158]

With emphasis on revenue effects during only the first five years, changes in timing that bring revenues forward, with little or no long-term gain in revenues look attractive. This ploy was used in 1986; this "revenue-neutral" legislation is expected to reduce revenues by almost $21 billion in 1992.[159] The structure of transition rules has also been affected adversely by the demands of revenue neutrality.

John Colvin, chief minority counsel for the Senate Finance Committee at the time the 1986 Act was enacted, has noted that the Budget Act, reconciliation, and the Gramm-Rudman-Hollings sequestration procedure have placed more focus on the revenue estimators.[160] This is in marked contrast to prior practice.[161] One observer has written the following: "In the past, policy makers were accustomed to making decisions on particular issues, and then receiving estimates of the effect of the provision on total tax receipts. While the estimates played a vital role in projecting the end result of legislation, the numbers did not dictate policy. However, the requirement that the tax reform be revenue-neutral changed all this."[162] Also, ". . .the Administration and the Congress had agreed to the principle that the tax bill should not raise more revenue than it lost, or vice versa. . . . For the first time, the numbers alone dictated what could and could not be done.[163]

This has not been a happy experience. One observer appraises it in the following terms:

> Congress has moved away from rate-setting adjustments, or the establishment of new levies, and relied on reform measures as the sole instrument for

raising revenue. This has profoundly changed the development of coherent tax legislation, exaggerating the problems described above by failing to rationalize or coordinate substantive revisions with the existing Code, encouraging "quick-fix" provisions to be adopted without real debate, and creating an environment in which lobbying ceases to be a legitimate activity to clarify and refine legislation, but rather becomes a tawdry practice outside of the public spotlight.[164]

Simon has echoed these sentiments: [S]ubstantive tax reform should be accomplished because it is sound tax policy regardless of its revenue impact. There is an inherent danger in using tax expenditures analysis for substantive tax changes at a time when revenue constraints are important. The danger is that revenue losers will not be enacted despite their theoretical appropriateness from a tax policy standpoint."[165]

An Alternative Process

A somewhat idealistic if naive view of the way income tax policy should be conducted runs something like this. First, you define full taxable income to approximate real economic income as closely as possible, given administrative realities and economic conditions.[166] Second, you allow for tax expenditures structured as deductions to the extent appropriate; this produces an estimate of the tax base.[167] Third, you add to the amount of revenue needed the amount to be spent via tax expenditures structured as credits, plus the foreign tax credit, and subtract amounts estimated to be raised from revenue sources other than the income tax; this gives needed before-credit income tax revenues. Fourth, you compare the tax base to the figure for needed before-credit revenues to determine the rates required to meet the revenue objective. (In the case of a flat-rate tax levied at the same rate on both individuals and corporations, this step involves simple division. In a world with progressive individual rates [and even graduated corporate rates, another anomaly of the present system], the process is only analogous to division.) Fifth, if revenue needs change, tax rates are adjusted.[168] Large changes in revenue needs might cause one to reassess deviations of taxable income from real economic income (allowed for either practical or tax expenditure reasons) and credits, but one would not ordinarily expect the basic decisions on the allocability of such deviations to be altered by changing revenue needs.

Several aspects of this hypothetical process are worth noting. First, taxable income is defined to approximate real economic income, except as dictated by practical considerations and modified by tax expenditures agreed to be appropriate. Both income-measurement issues and deviations of the tax base from economic income are decided as a matter of principle, largely independently of revenue needs. This implies that the type of revenue-neutral redefinition of the tax base we have seen recently would generally make no sense. Second, tax rates are a residual in this calculation, determined by the interplay of revenue needs and the tax base (and credit-type tax expenditures).

In such a world, the charge to the tax committees might include a mandate that tax rates be raised (or lowered) by enough to meet reconciliation targets; it presumably would not ordinarily include changes in the base. (How the pattern of automatic rate changes

would be determined need not concern us in this simplistic description.) Third, it might very well be that federal spending would be greater under this system than the present one; that would depend on the relative strength of those who do and do not want tax rates to be raised.

In this idealistic view of things, the tax system would be less complex. The complexity that results from rules for accurate income measurement would not be avoidable, and the provision of tax expenditures would also complicate matters. Moreover, some backstopping rules would be necessary to prevent arbitrage resulting from the inherent inconsistency of rules based on both accrual and realization. But the other types of complexity identified in section III would be minimized. That is, there presumably would be less need for backstop provisions if taxable income reflected economic income more closely. (There might still be a call for backstop provisions if taxpayer use of tax preferences was thought to create perception problems. This is one of many reasons not to use tax expenditures to accomplish social and economic goals.) And in an orderly process the various provisions of the tax law would be coordinated much more closely than at present. With the tax law (aside from rates) being less subject to change for revenue reasons, there would be less need for transition rules. Transition rules would be based on principle, and not revenue.

Under current practice, this process is stood on its head. Tax rates are fixed by presidential fiat. This means that if revenue targets are to be met, it is the tax base that must be adjusted. Income measurement is made to reflect economic income more or less closely, depending on revenue needs and the effect a particular proposal would have on the ability to meet those needs (and, of course, the relative ability of lobbyists). Transition rules are structured with revenue consequences in mind. In short, the process of tax reform has become driven by revenue needs and revenue estimates.[169]

Of course, we do not start with a tax structure that has been created by following the rules outlined earlier. Tax expenditures of dubious merit permeate the system. As a result, revenue-driven tax changes may bring improvements in areas that have long resisted reform. Such reforms may clearly be preferable to raising rates on those who are already paying their fair share of taxes. There is little doubt that more true tax reform has occurred since 1981 than in any comparable period in the history of the Code.[170] This must give pause to anyone who would advocate the "rates-only reconciliation" procedure discussed below.

The Deficit and Complexity

To this point, primary emphasis has been on the budgetary process and complexity.[171] What may not be fully appreciated is the enormous role the budget deficit plays in this drama. If there were no deficit problem, it is much less likely that the Congress would be measuring revenue effects in teaspoonsful or that "no new taxes" would be a seriously binding constraint on policy-makers; in that case, the budget process would almost certainly not have created the machinations and the complexity we have seen since 1981.

One possible interpretation of events of the past decade is that the budget deficit, together with the reconciliation process, has opened up the tax-writing process as never

before to the influence of non-experts in the Congress--non-experts who have little appreciation for the damage their seemingly well intentioned proposals can wreak on simplicity (not to mention equity and neutrality) and no allegiance to a coherent and stable tax system.[172] According to this view, it is not the budget process per se that is to blame for complexity; it is the deficit. As James Verdier has expressed it in personal correspondence with the author, "The problem is not the process; the problem is the problem."

WHAT TO DO

Prescribing a solution to the problems identified in this paper is no easy task. To some extent, the problems can be traced directly to the system of checks and balances included in the Constitution, and to the system of government it has produced. As in so many areas, the pluralism that is the strength of the American political system is also its weakness.[173] It is clearly not productive to suggest fundamental changes in this system, since to do so would take us well beyond both the topic of this paper and the realm of political reality--not to mention the expertise of its author. Rather, we focus more narrowly on changes that would improve the tax legislative process, given our basic political institutions.[174]

Part of the objective is to create a framework for decision making that produces results similar to those under the ideal system described at the end of the last section--a description acknowledged to be naive. The need to create an improved framework for decision making is emphasized because otherwise, we are left with little but platitudes urging the Congress and the president to act responsibly in the formulation of tax policy. As Rudder has noted:

> [R]ules and procedures matter, since they structure the situation in a particular way. . . . The bias needed in tax policy is one of responsibility, defined here as a concern for raising appropriate levels of revenue fairly, efficiently, simply, and in a manner consistent with other element of fiscal policy.

To do that, the legislative process must be structured to permit careful consideration of the implications and long-run consequences of proposals. Deliberation of this sort is not facilitated by the current policy process.[175]

The following discussion of potential solutions is intended to be provocative, rather than to advance definitive proposals. (I am not even sure where I stand on some of these proposals.) It begins with a suggestion that involves relatively little departure from current practice and then proceeds to one that involves a more fundamental restructuring of the way tax legislation is considered in this country. It ends with the possibility that perhaps the budgetary process (or at least the tax-writing part of it) does not need to be changed--at least not to address the complexity problems identified in this paper.

"Rates-Only" Reconciliation

One possibility would be to legislate a procedure similar to the ideal solution described above. That is, there would be a presumption that revenue target for reconciliation would be met by changes in rates, rather than by changes in the base. The reconciliation mandate might also specify that a fall-back increase (decrease) in rates would automatically be implemented via a surcharge (proportionate reduction in liabilities) in the absence of adequate revenue-raising (reducing) action by the tax committees and the two houses.[176] This would preserve the committees' latitude to make changes in the tax base or the level and pattern of rates (or in other sources of revenue), in order to prevent the automatic changes from coming fully into effect. (Presumably, partial solutions would be acceptable, with automatic changes in rates occurring only to the extent that application of existing rates--possibly to an expanded base--would not raise the mandated revenue.) This approach appears to be broadly consistent with that suggested by Handler, who would prohibit reconciliation from containing any substantive reform. He writes:

> The budget reconciliation process, as valuable as it may be in controlling the budget, must not be allowed to control substantive tax revision. While there is no question that substantive tax reform is necessary, . . . the budget reconciliation process is clearly not the appropriate legislative environment. The coherence and substance of the Code would be better served if political considerations were allowed to affect only the rate of tax, or the type of tax imposed. . . . <u>Thus the budget reconciliation process should be prohibited from containing any substantive reform</u>. If revenues need to be raised, Congress should adjust rates, establish new forms of tax, or adopt other forms of revenue-raising techniques that are unrelated to substantive tax reform. [Emphasis added.][177]

There are some obvious problems with this approach. First, in an environment permeated by presidential promises of no new taxes (and no increases in old ones), there is the risk that nothing would be done about the deficit. But this outcome may be somewhat less likely to produce undesirable results than it appears at first glance. There are several possible scenarios. First, the Congress might decide to reduce federal spending. Second, it might try to raise taxes, thereby incurring a veto that, if sustained, would lead to a legislative stalemate and sequestration. Third, the president might give in, either when presented with reconciliation legislation that raised taxes or in anticipation of an over-ride of his veto. Fourth, his veto might be over-ridden. Fifth, the Congress might do nothing. We examine these alternatives.

In principle, one can hardly object to the first, third, and fourth outcomes. If the Congress accedes to the wishes of the public for no new taxes, as personified in a strong president, and for reduced spending, or if the president gives in to the Congress and allows it to raise taxes, democracy would have worked, at least by some definitions. (Of course, advocates of greater or lesser spending or of deficit reduction may object to the actual outcome, if not to the principle.) Indeed, the rates-only approach to reconciliation has the advantage of helping to break the present stalemate in which the president says, "no

new taxes," and no one in Congress has the courage to try to "bell the cat" by proposing a tax increase; at least there would be a process that would force the Congress collectively to confront the president with some kind of action, so that the American public can have a legislated decision on the question of whether taxes should be raised, rather than a decision (more accurately, a non-decision) by default.

The prospect of a legislative stalemate and sequestration is more troubling if, as now, sequestration is limited to spending; after all, sequestration is a terrible way to set budget priorities. But the sequestration process could be redesigned to trigger an automatic tax increase as well as spending cuts. This might have a salutary effect. Whereas the effects of across-the-board sequestration of spending are diffuse and not readily noticed, even a small across-the-board tax increase would gain immediate and adverse public attention. It probably would not take much experience with sequestration-cum-automatic-tax-increase for the American public to demand that the Congress and the president act responsibly.

There is another more troubling problem with a rates-only reconciliation rule. We are not starting from an ideal system that approximates the taxation of economic income, with only a few well-chosen tax expenditures; the present system is badly flawed and is in need of further fundamental reform. Recent experience with policymaking under the gun of reconciliation and revenue neutrality has brought with it some benefits, in terms of a tax system that is fairer and more neutral, as well as substantially more complicated for some. After all, it was the fact that some taxpayers were getting away with murder that made it possible to use the cats-and-dogs approach to achieve some reform while raising revenue in 1982 and 1984 and to achieve fundamental reform in 1986.[178] Under a rates-only rule, much of the pressure that has brought this type of improvements would be gone. The question, then, is how to institutionalize tax reform, so that progress continues to be made in the absence of budgetary pressure. A full answer to this question would take us somewhat beyond the terms of reference for this paper--though not much beyond, since until one has answered it, one cannot be confident one is not throwing out the baby (the possibility of tax reform for equity, simplicity, and economic neutrality) with the bath (prohibition of structural reform for purposes of reconciliation).

One part of the answer is to note that there is no reason for a strict rates-only rule; the tax committees could be left the option of changing the base. It might be argued that this would leave the status quo largely unchanged; after all the committees now have the prerogative of changing either the base or the rates. But there is a potentially important difference. The advantage of a default "rates automatically as a last resort" rule is that it provides the tax committees with cover in case they fail to increase the base enough to avoid a rate increase; by voting for a reconciliation with a change in rates to be triggered in the absence of adequate base-broadening, the entire Congress would be on record. In a sense the "bell the cat" problem is handled automatically under this process. Of course, it remains an open question how, from a political point of view, automatic tax increases could ever be added to the sequestration process, since the effort to do so would probably be attacked as a thinly veiled plot to raise taxes.

A More Radical Proposal

Much of the current complexity in the income tax--and much of the inequity--results from the efforts of the Congress to fine tune-tax legislation, not to improve it, but to satisfy the pleadings of special interests. Witte describes the problem as follows:

> The answer is not to reform the representative process but to insulate policy from it. . . . What is implied is that democracy must be contained--that it must be tempered to prevent elected officials from offering constituents, in good conscience, what those constituents want. The underlying malady is the hyperresponsiveness of the system. It is not that the 'electoral connection' is too loose or disjointed; it is that it is too much tied to personal interests, too shortsighted, and too often exercised. Decisions that appear rational and proper in each individual case are in the aggregate and over time a disaster."[179]

Witte is suggesting that details are legislated that be better left to administrative directives.

Simon has employed a "separation-of-powers" argument to reach the following strong conclusion:

> Looking at the recent past and the legislative morass that has developed in the tax area, it is clear that we are in the precise state that the Framers sought to avoid. Congress has, in many situations, seized control of the detail of the tax laws. This tendency has made the laws themselves hypertechnical and hence susceptible to frequent change, with the result that they are almost unadministrable. If the laws that Congress writes were simpler, the proper role of Treasury in the governmental process would be better preserved. The management of detail would be entrusted to the executive branch, where it properly belongs. In that way the structure adopted by the Framers would be respected and its purpose of guarding against tyranny would be best effectuated.[180]

Supposing that this viewpoint is accepted, which types of details should be delegated? And to whom should authority be delegated?[181]

In answering the first question, it seems useful to distinguish between those sources of complexity that result from decisions the Congress should make and those it currently chooses to make but could better delegate to others. It appears that the Congress must retain responsibility for what has been identified earlier as basic income-definition rules, general tax-expenditure rules, basic backstop rules, and true transition rules of general applicability. By comparison, it has neither the time nor the expertise to deal with derivative income-definition rules, derivative tax-expenditure rules, derivative backstop-rules, or technical changes needed to bring coherence to the law.

The Congress should not simply be absolved of blame for complexity, as it appears Chapoton would do, when he writes, "It is not correct, however, to indict the members of the tax-writing committees for the internal complexity of the rules they adopt. The members should and must rely on their staffs with respect to technical matters, and reducing complexity is a technical matter."[182] If the buck does not stop with the elected members of Congress, where will it stop? Surely not with Congressional staffs.

More important, it is highly inappropriate, as a matter of principle, that the Congress be engaged in the business of providing highly targeted tax expenditures or targeted transition rules.[183] Simon has argued the last point in the following terms:

> In a sense, the grant of a special tax break that no one else gets is analogous to a grant of money from the Treasury. . . . In general, however, it is clear that the authority to make grants of money is an inherently executive one, normally exercised under guidelines set out by Congress in general legislation. . . . By writing special tax laws that allow only a select few to receive monetary benefits in the form of reduced taxes, Congress exercises an executive power that it properly should delegate to an agency with the requisite expertise to make determinations of merit. Congress should not on its own elect to decide which taxpayers are entitled to relief from general laws.[184]

Having said all this, one must admit that it would inevitably be difficult to distinguish between the basic rules that should be written by Congress and the derivative rules that would be similar to regulations of those rules and thus should be off-limits to Congress. Moreover, there is the concern that tax law will be too complicated if left in the hands of the experts--who understand their own specialty well (perhaps too well) and will try to tie down all the loose ends. (See also the discussion of a simplification czar that follows.)

If authority for details of tax law is to be delegated, the two obvious alternatives for the delegee would seem to be the staff of the Joint Committee on Taxation and the Treasury Department, including the Internal Revenue Service. Given that, it seems clear that Treasury is the appropriate choice for several reasons.[185] First, Treasury, in conjunction with the Internal Revenue Service, is already involved in writing regulations; the preparation of details on tax law would be a natural extension of that function.

Second, though it is clearly far less political than the staffs of members, the staff of the JCT is simply too close to the members on the tax writing committees. It would be too difficult to avoid pressures to insert provisions favorable to constituents into ostensibly objective renderings of the details of general laws passed by the Congress.

It may be objected that a similar risk would arise at Treasury, given the susceptibility of the White House--and thus Treasury--to political pressure to support tax breaks for special interests; certainly the gutting of Treasury I on the way to the Congress as the President's 1986 proposals for tax reform gives one pause.[186] Several considerations suggest at least guarded optimism on this score. First, whereas everyone might expect the staff of

the JCT to be somewhat compliant in meeting the desires of members, similar Treasury Department compliance to pressure from the White House would probably be seen as scandalous, especially once the nature of the new process was appreciated. Indeed, it can be argued that whereas it is currently acceptable for political pressure to be exerted on both the Congress and the White House, similar pressure on the interpretative division of the Treasury would not be permissible.

Second, and supporting this view, it appears that Treasury and the IRS have generally been relatively immune from political influence in the promulgation of regulations. It does not seem impossible that, if charged with responsibility for putting flesh on relatively bare-bones legislation, the Treasury and IRS could discharge that duty in an impartial manner. The ability to withstand political pressure in attempting to determine depreciable lives of assets, as required by the 1986 Act, will be a test of the feasibility of this approach.[187]

Some may argue that the Treasury and IRS have shown scarce little concern for simplicity in either legislative proposals or regulations in the past. Former IRS Commissioner Egger does not provide much comfort when he admits candidly that "because most of the regulations issued by the Service are interpretive regulations as distinguished from so-called legislative regulations, and (sic) they are not really subject to any significant administrative impact review." Chapoton notes, by way of explanation, "History clearly teaches us that conceptual purity and comprehensiveness will win the hearts of the very able individuals who devolop (sic) technical policy rules; simpler, less precise rules will not as quickly capture their enthusiasm."[188]

Both Egger, with his requirement for sign-off from the taxpayer ombudsman, and Chapoton, with his "simplification czar," would combat this tendency by placing a watchdog over these bright individuals who seemingly do not understand that simplicity is prized for its own sake. I agree with the view that only the assistant secretary for tax policy can serve as the simplification czar, since anyone else is likely to be ignored. (Of course, the assistant secretary could properly assign staff responsibility for being on the lookout for complexity to one or more individuals.) The assistant secretary and the IRS commissioner can emphasize to their staffs (a) that simplicity is inherently important, and not merely a luxury that is nice to have once all the technical details have been solved, and (b) that those who write complicated laws when simple ones would do almost as well are not doing--and may not continue to hold--their jobs. In addition, it seems appropriate that general explanations of legislative proposals include as a matter of course a discussion of whether and how complexity will be affected, along with discussions of the reason for the change, the economic effects of the change, and the revenue implications of the change. This would at least help assure that someone has focused on the issue.

It seems almost inevitable that such a system would result in substantial litigation as taxpayers questioned the interpretation of basic laws. This might lead some to argue that uncertainty would be increased by this change in procedures. I am inclined to agree with Mattson's view that "more intricate language in the statute leads to greater uncertainty." Even if there were more litigation, this would seem to be consistent with the separation of powers under which the Congress makes the laws, the Executive branch enforces them, and the judiciary assures that enforcement is true to the intent of legislation. Of course, it

might be necessary to make important changes in the judiciary system dealing with tax matters. Such changes are beyond the scope of this paper.

This proposal suffers from several important political problems. First, while it might be true that the system outlined would protect the integrity of a good system--one based more closely on economic income--one wonders whether fundamental reform of the existing highly flawed system could ever occur. Such a reform would slaughter sacred cows, with no opportunity for legislated relief through targeted transition rules or other sweeteners. Experience suggests that those benefitting from existing tax preferences would fight hard, and perhaps successfully, against broad-brush reforms that contained no such sweeteners and left the details to an impartial interpretive agency of government.

A final question is how to get the tax writing committees to give up their present power, which conveys enormous potential for favoring supporters and punishing opponents.[189] On that the present author has no special advice. The real issue is whether the members of these committees will be allowed to continue to subjugate the public interest in tax simplification to their own desires to maintain control of details of the tax reform process in order to help assure their reelection.

Do Nothing

According to one line of reasoning identified earlier, the problems we have described above have relatively little to do with budget process, per se, and everything to do with the state of budgetary balance.[190] In this view, if, as, and when we deal with the federal budget deficit, rationality will return to the tax-writing process. If that is true, there may be little need for the type of changes just discussed.

There is much to be said for this view.[191] Yet I believe it goes too far. It seems that rates-only reconciliation may generally be a sensible approach to the revenue side of reconciliation, even in more normal times. If small amounts of revenue are needed--or if small tax reductions are needed--it seems far more sensible to adjust rates slightly than to change the tax base. (This is not to say that rate changes should be used for fine-tuning the economy; that is a topic this paper properly does not address. But whatever type of tuning is at issue, rate changes are generally more appropriate than changes in the tax base.)

The other problem with the do-nothing approach is that, like the rates-only approach, it makes no contribution to the improvement of the tax base, whatever it does to reduce the growth of complexity. There may be something to be said for insulating the process of policy-making from the grossest types of pandering to special interests. This is true whether we solve the deficit problem or not.

NOTES

[1] Bradford (1986), 266. Witte (1985), 68, argues along the same lines:

> [T]here is overwhelming consensus among tax experts that voluntary compliance is absolutely essential in collecting income tax revenues. Voluntary compliance depends on both the capacity of taxpayers to understand the tax code and on their willingness to comply. The complexity of an income tax system loaded down with the sort of tax-reducing and tax-delaying devices that characterize the U.S. system affects compliance and legitimacy in several ways. ... [I]t is difficult for many people to understand the intricacies of the tax system that is extracting their money. The system also gives an impression of special privilege--of "loopholes" that exist primarily for the wealthy....
>
> Additionally, while we know little about the psychology of tax avoidance. it is reasonable to assume that the easier it is to go undetected, or the easier it is to escape punishment once caught, the greater the temptation. Complexity allows both in that it makes the task of enforcement significantly more difficult, and it makes it easier to plead ignorance or error when the intent was truly fraud. Notes that this quotation contains an important element of an argument for "simplicity for the other guy," as well as for simplicity, per se.

[2] McDaniel (1979), an excellent and far-ranging paper on tax simplification written for a conference in January 1978, less than four years after passage of the 1974 Budget Act, devotes less than five pages to the topic.

[3] Rivlin (1987), 6, notes, "Recent experience with trying to reduce the federal deficit along the fixed path specified by the Gramm-Rudman-Hollings amendment, for example, has given us a taste of some of the possible disadvantages of a balanced budget rule." Rivlin goes on to say, "The Gramm-Rudman-Hollings experience, however, has suggested the usefulness of a different approach to deficit reduction than a balanced budget rule; namely a deficit neutral amendment rule." (The difference in these two rules is that under the former total receipts must be at least as great as total expenditures, whereas under the second a change in policy could not increase the excess of expenditures over receipts.) Part of the implicit purpose of this paper is to shed light on the net benefits of such a rule.

[4] Surrey (1970), 691.

[5] On the plan to finance catastrophic health insurance passed in 1988, Steuerle (1989), 455, has written:

> Too little attention to the financing side of the issue has now left Congress in a quandary. The surtax that was enacted is too complicated for the amount of revenues generated and is barely administrable by the IRS. It involves

grafting an annual collection process on a monthly benefit system, which is akin to grafting tree branches onto leaves of grass and hoping that the hybrid is going to bear fruit months later. It appears that this program will be repealed for political reasons having little to do with its complexity.

[6] For this reason, it appears that David Bradford's suggestion in his comment on my paper at the AICPA/ABA conference that there is no economic difference between budgetary expenditures and tax expenditures is largely beside the point (besides failing to deal with the perception problems of tax expenditures, to be discussed below). If it is the budgetary balance that is being controlling, nothing is gained from converting budgetary expenditures to tax expenditures.

[7] Since the focus of the paper is fairly narrowly defined as the impact of budget process on tax simplification/complication, there is no attempt to provide an overall appraisal of the end product of tax reform or to discuss the political process, more broadly defined, that led to tax reform. See, however, Birnbaum and Murray (1987), Doernberg and McChesney (1987), Galvin (1987), Minarik (1987), Verdier (1988), Witte (1989), Conlan et al. (1989), and Strahan (1990).

[8] McDaniel (1979).

[9] See, however, Bradford (1986) and McLure (1988). I must not let the opportunity pass, especially with David Bradford as one of my discussants, to emphasize that many of the most important sources of complexity, those associated with timing problems, simply do not exist under a consumption-based direct tax.

[10] As Bradford (1986), pp. 276-80, notes, much of complexity can be traced to graduated rates. See also Hall and Rabushka (1983) and (1985).

[11] On this topic, see, for example, McIntyre and Oldman (1977) and the papers in Penner (1983).

[12] On this act and its consequences for the tax-policy process, see inter alia, Shuman (1984), chapters 8-10, Ellwood (1985), and Simon (1988), 628-30.

[13] In earlier years, the Budget Committees made abortive attempts to mandate the particular means of raising revenues; these were rebuffed by tax-writing committees jealous of their constitutional prerogatives. See McDaniel (1979), 537-38, and Davenport (1979), 263-64.

[14] Leonard (1988), 973.

[15] Leonard (1988), 971.

[16] The 1981 act is estimated to reduce fiscal 1990 revenues by $323 billion ($398 billion in 1992). TEFRA and DEFRA reduced this by only $88 billion ($103 billion in 1992). Even after all subsequent revenue legislation, including the 1983 amendments to social

security and the ill-fated catastrophic medical care legislation, estimated revenues remain $195 billion ($258 billion in 1992) below their projected level under pre-1981 law. See Budget of the United States Government, Fiscal Year 1990, 4-4.

[17] Minarik (1987), 1359.

[18] This discussion draws on Ellwood (1985).

[19] There is another conceptually different but important form of adjustment for inflation, which also has never been enacted in the United States. Inflation distorts the measurement of income from business and capital when such measurement is based on historical (unindexed) values of assets and liabilities. This is discussed briefly in section III.

[20] For an excellent description of the effects of bracket creep, see Steuerle and Hartzmark (1981).

[21] Growth in real GNP also generates a fiscal dividend, in the sense that taxes grow with output. Indeed, with a progressive rate structure, taxes can be expected to grow as a percentage of GNP. The reduction in the progressivity of the rate structure during the 1980s reduces this source of increase. This type of fiscal dividend is not the subject of the present discussion.

[22] Verdier (1987), 172.

[23] Leonard (1988), 971.

[24] Leonard (1988), 971. On the growth of tax expenditures, see Witte (1985), chapter 13. The concept of tax expenditures is discussed in Section III and in Special Analysis G of the U.S. Budget. It should be noted that it is generally inappropriate to add together the amount of individual tax expenditures; it is done here only to provide a rough indication of the growth in the use of the tax system to interfere with market decisions.

[25] Kies (1987) emphasizes the importance of indexing in creating a watershed between pre-ERTA and post-ERTA policymaking. As a consequence of indexing, "legislation must in the aggregate either raise revenue, or at least not lose revenue." He notes, "in the post-ERTA period, it is common for Members to request a revenue estimate of a bill before its introduction, much less actively urging its enactment. This approach contrasts with the pre-ERTA period when it was not uncommon for a tax-writing committee to complete consideration of legislation without knowing its revenue effect." These quotations are from page 182.

[26] Merrill, Collender, and Cook (1989).

[27] Leonard (1988), 972.

[28] By far the largest increase in non-defense spending was, of course, for social security.

[29] Surrey (1979) provides a detailed discussion of the passage of the 1978 tax act that suggests that the tax revolt had reached Washington before Ronald Reagan became president.

[30] Minarik (1987), 1364.

[31] U.S. Department of the Treasury, (vol. 1, 1984), 14.

[32] On the importance of the discipline enforced by the requirement of revenue neutrality, see Birnbaum and Murray (1987), Conlan et al (1989), and Verdier (1988).

[33] Birnbaum and Murray (1987), 287. See also Verdier (1988).

[34] For a detailed discussion of the two alternative methods of implementing consumption-based direct taxes, see Zodrow and McLure (1988).

[35] It is true, of course, that such efforts are fully funded.

[36] See, however, Summers (1989). Among the obvious examples of fiscal craziness outside the tax area are the various schemes that were considered to keep the cost of bailing out the savings and loan industry from being reflected in the budget deficit and thus triggering sequestration under Gramm-Rudman-Hollings

[37] This point is made in Merrill, Collender, and Cook (1989).

[38] McDaniel (1979), 509.

[39] This discussion draws heavily on Bradford (1986), chapter 12. See also the discussion of different types of complexity in Koppelman (1990).

[40] Bradford (1986), 267.

[41] For some potential investors in tax shelters the mere prospect of a compliance burden of staggering complexity may be enough to deter investment, even if tax benefits are not eliminated. More commonly it is the elimination of the tax benefits that can be expected to deter investment.

[42] This discussion draws heavily on McDaniel (1979). Note, however, that McDaniel considers only the first two categories of complexity identified here, income-measurement rules (which he dubs "structural") and tax expenditures. He appears to be much more sympathetic than the present author to the use of tax expenditures for the achievement of social and economic objectives. He argues that complexity exists in part because rules written with a tax mindset are not necessarily appropriate for a tax expenditure program. Some such complexity could be identified with the "backstop" provisions of the current discussion.

[43] For a discussion of the Haig-Simons definition, see Bradford (1986), chapters 2 and 3.

[44] Actually there is no real need for installment sales rules. Existing rules--and their predecessors--are examples of what happens when special treatment is provided via special rules that are not appropriate.
[45] By comparison, timing issues and problems of inflation adjustment (to be discussed below) largely disappear under a system of direct taxation based on consumption, which utilizes cash-flow concepts; see, for example, Bradford (1986), McLure (1988), or Zodrow and McLure (1988).

[46] The description that follows is based on Graetz (1988), 954-59.

[47] The 1984 act also requires that market discount be treated as ordinary income, rather than capital gain, but does not require current taxation on an accrual basis; thus market discount is now taxed on the same basis as OID under pre-1969 law. Graetz (1988), 958, notes with regard to market discount, "Future adjustments seem likely."

[48] How closely the definition of income for tax purposes should mirror economic income is a matter of judgment. Clearly it is possible to go too far in specifying complex rules in the attempt to achieve congruence between taxable income and economic income; some would argue that this was done in Treasury I (U.S. Department of the Treasury, [1984]). What is required is a more refined version of what is often called "rough justice" in the literature on taxation in developing countries.

[49] Thus Brockway (1986), 1804, has written, "after laws have 'been on the books' for a period of time, taxpayers against whom the laws are directed devise loopholes' or plans to get around them. Congress in turn is forced to come up with increasingly complex rules to close loopholes--the result being a Code that is several volumes thick and difficult to use."

[50] See also U.S. Department of the Treasury, vol. 2, (1984), chapters 8 and 9. For a more exhaustive discussion of inflation adjustment, see McLure et al. (1989), chapter 7.

[51] On this, see Surrey (1969), 679-82.

[52] See McLure (1979).

[53] The classic reference on tax expenditures is Surrey (1973). See also Surrey and McDaniel (1985), Witte (1985), and Thuronyi (1988b).

[54] This characterization, in terms of deviations of taxable income from economic income, is not totally accurate, because some tax expenditures take the form of tax credits. A more satisfactory characterization might be deviations of tax liabilities from those that would result from application of the statutory rate structure to economic income. The description in the text appears satisfactory for present purposes. Note that neither of these is the definition actually used in preparation of the tax expenditure budget; see also the discussion in subsections 6 and 7 below.

[55] Perhaps it should be noted that the tax expenditure concept made its public debut in official government publications in 1969 in the Annual Report of the Secretary of the Treasury for Fiscal 1968.

[56] It should be noted explicitly at this point that the tax expenditure concept used to prepare the tax expenditure budget does not adhere slavishly to a definition couched in terms of deviations from the pure concept of economic income; as noted in Section III, it modifies that concept in the interest of practicality.

[57] McDaniel (1979), 528-29.

[58] See Birnbaum and Murray (1987), 11-13, for a description of the political use made of the fact that wealthy individuals and large corporations paid no income tax in gaining passage of the 1986 Act.

[59] Sunley (1986) notes that we now have three corporate taxes, each with its own definition of income and its own rate: the regular tax with ACRS depreciation and a 34% rate, the "regular" minimum tax with non-incentive depreciation and a 20% rate, and the minimum tax based on book income with book depreciation and a 10% rate. In addition, Simon (1989) notes the need to calculate earnings and profits.

[60] On this point McDaniel (1979), 514, has written:

> It makes no sense in a spending program. What secretary of commerce would suggest, or even think of, limiting a direct subsidy for machinery and equipment to a percentage of the recipient's tax liability to the Treasury Department?

[61] McDaniel (1979), 515. Kies (1987) suggests that there may be pressure to impose limitations on leasing induced by the AMT based on the excess of book income over otherwise minimum taxable income.

[62] In private correspondence with the author, Paul McDaniel has suggested that this assessment may be overly optimistic, since transactions are being structured in extremely complicated ways in order to circumvent the PALs.

[63] Birnbaum and Murray (1987), 88, describe the following episode during the process leading to the 1986 act in which cynicism about the perception of equity reached its apex:

> Baker and Darman wanted to make certain those stories about millionaires and corporations escaping all taxes never surfaced again. Baker even suggested an unusual proposal requiring large companies with no other tax liabilities to pay one dollar tax.

Sunley (1986), 137, provides the following more favorable assessment of minimum taxes:

> Many might view the enactment of minimum taxes as a sign that basic,

> comprehensive tax reform had failed or is unattainable. If the United States ever adopted a truly comprehensive income tax, the minimum tax with all its complexities would presumably not be needed....I do not view the enactment of a minimum tax as a sign of failure. Instead, it is an admission that the U.S. income tax involves tradeoffs among competing objectives....A minimum tax can ensure that no taxpayers with substantial economic income can reduce their tax liabilities to zero by combining tax preferences. But this objective can only be achieved at the cost of considerable complexity and a blunting of incentives.

Steuerle (1986) adds another interesting explanation for the use of backstop provisions having its origin in the structure of the economic model used by the Joint Committee on Taxation to estimate distributional effects of tax changes: "The tax model will readily show an increase in tax on those subject to higher minimum taxes but, because it does not impute to partners particular partnership items, it will not show any increase in tax on partners if direct changes are made to items of preferences used by partnerships." By comparison, estimates of the distributional effects of Treasury I, which significantly did recommend the repeal of the minimum tax, did take account of the distributional effects of a frontal attack on the preferences that give rise to tax-shelter partnerships.

[64] For a masterful discussion, see Surrey (1969), 686-89.

[65] This is one of the important themes of Witte (1986), who on p. 257, also describes the problem as follows:

> [A]lthough incremental changes are by definition non radical departures from the status quo, it is a major error to interpret the long-term result of this process or producing little change. The reason is that modifications are <u>cumulative</u>. This simple fact has produced the policy results with which we are all so familiar--a hopelessly large tax code that is unbearably complex, and riddled with particularized sets of benefits for all ranges and types of taxpayers.

[66] Witte (1986), 369-70.

[67] Handler, (1987), 1260-61. It may be worthwhile to note at this point that the author of the present paper is an economist; being neither a tax lawyer nor a tax accountant, he is at somewhat of a disadvantage in specifying particular instances of incoherence and other types of complexity that are well-known to practitioners.

[68] Schenk (1990).

[69] Minarik (1987), 1363.

[70] Chapoton (1990).

[71] Handler (1987), 1260.

[72] Simon (1988), 630-34 comments on the difficulty of defining tax expenditures, noting (632) that, "the malleability of the concept is troublesome" and suggesting, regarding the inclusion of the effects of General Utilities as a tax expenditure, that "a desire to achieve certain social and economic goals by eliminating it played a part in the classification." See also Thuronyi (1988b), which came to my attention after this paper was essentially completed.

[73] Special Analysis, 1976 101-4.

[74] Special Analysis G. 1983, G-5.

[75] See McDaniel and Surrey (1982) and Surrey and McDaniel (1985), 194-96.

[76] Inequities, as well as the pressures to transfer deductions to high-income taxpayers that create tax shelters and perception problems, result from the inverse subsidy characteristic of deductions; deductions are worth more, the higher the marginal tax bracket of the taxpayer.

[77] Accelerated depreciation is perhaps most accurately treated as a tax expenditure, rather than as merely a failure to provide adequate income measurement rules. In the context of inadequate income measurement rules, the discussion that follows is most appropriate to a system that simply leaves the choice of depreciation methods to the discretion of the taxpayer.

[78] See Feldstein (1981) for this line of argument. It is worth noting that while inflation adjustment is complicated, it is clearly feasible. Chile has had a comprehensive system of inflation adjustment based on adjustment of items in the balance sheet for over a decade.

[79] See U.S. Department of the Treasury, vol. 2, (1984), chapters 8 and 9, for the elaboration of this argument.

[80] For a less pessimistic assessment, see McDaniel (1983). Note, however, that at the time McDaniel's paper was written, the nation had barely begun to experience the related phenomena of abusive tax shelters and high-income individuals and corporations paying no taxes as a result of the provisions of ERTA.

[81] Under the "hang 'em high" theory of punishing evasion, high-visibility tax evaders are given stiff penalties, and even prison sentences, in order to deter others from engaging in similar practices. Conversely, the spectacle of wealthy individuals and corporations paying no taxes may encourage evasion.

[82] The METR is calculated as the difference between the before- and after-tax rates of return, divided by the before-tax return. For the basic methodology, see King and Fullerton (1984).

[83] Waste is not inevitable, since social benefits of activities subsidized through the tax system may exceed private benefits. Yet there is a high probability that in many cases, even taking account of external benefits, costs of tax expenditures exceed benefits.

[84] Arthur Andersen (1986), 120 and 129; the second sentence quoted refers to the calculation of "adjusted current earnings."

[85] Chapoton (1990) distinguishes between three groups. For his level-one taxpayers, "who are not self-employed, have no investments that raise tax complexities, do not itemize deductions, and have no unusual events during the taxable year...the tax system is not unduly complex." For his level-two taxpayers, "who itemize deductions, or invest in partnerships, or have unusual tax events during the year...the tax system becomes considerably more complex...The overwhelming majority of taxpayers who address level-two complexities do not engage in any substantive tax planning...[T]ax complexity for them is primarily the difficulty of accounting to the government after the fact." "Taxpayers who seek tax assistance in planning business, financial, and professional transactions and events--which includes most medium and large business taxpayers--face an entirely different type of complexity," what Chapoton calls level-three complexity. "For such taxpayers, complexity means either lack of certainty in the tax rules or that a satisfactory level of certainty can be achieved only at excessive cost...[V]irtually all anti-abuse amendments to the Code are aimed at level-three taxpayers." Shapiro (1990) confirms that for individuals the issue of complexity revolves around tax planning.

[86] Schenk (1990).

[87] One the complexity of recordkeeping for this group, see Schenk (1990).

[88] Speaking of the effects of the 1986 Act on essentially this group, Shapiro (1990) has written, "the additional complexity was enormous."

[89] McLure (1988), 303.

[90] For examples of incoherence in this area, see Kautter (1990).

[91] For a detailed assessment leading to the same conclusion, see Koppelman (1990). He notes, "PALs (passive activity limitations) represent the broadest attack ever launched against tax shelters. They have virtually shut down the tax-shelter activity in this country." He also argues, "Notwithstanding the length of PALs, they represent, in my opinion, ... a net simplification of the system."

[92] I sometimes call this the "vampire approach." In order to be safe when dealing with a vampire, one drives a stake through the heart, hangs a cross around the neck, places a mirror over the eyes, and fills the coffin with wolfsbane. (I acknowledge my indebtedness to Victor Thuronyi for pointing out the error in an earlier draft, where this was identified as the "werewolf approach.")

[93] See, however, the contrary views of Graetz (1977) and Kaplow (1989). These are also discussed in Zodrow (1989). Of course, this is not to say that investors in shelters who had taken deductions at pre-reform tax rates should have been allowed to enjoy the full benefits of rate reduction. On this, see the proposal for a "windfall recapture tax" in *The President's Tax Proposals* (1985), pp. 192-96.

[94] This discussion draws on Koppelman (1990).

[95] Koppelman (1990).

[96] Sunley (1986) makes this point.

[97] It might be relatively unusual that unsecured debt is used to purchase a house. But see the discussion of the fungibility of money that follows.

[98] Doernberg and McChesney (1987), 912-13.

[99] It might be worth noting that the true tax expenditure in this case is the failure to tax the gross imputed income from owner-occupied housing; if such income were taxable, the deduction for mortgage interest (and for the property tax) would be perfectly appropriate as an expense of earning income. Much the same thing can be said about interest incurred to finance the ownership of municipal bonds, but here policy has long forbidden the deduction of such interest.

[100] On the rationale for the kiddie tax, see Thuronyi (1988a).

[101] For such an argument, see Thuronyi (1988a), 597-600.

[102] For a clear discussion of this issue, see Ginsberg (1990).

[103] Without indexing, however, tax may be collected on fictitious (inflationary) gains. It may also be worthwhile to note explicitly an often-neglected fact--that because of the benefits of deferral, capital gains would remain tax-preferred if they were indexed and taxed as ordinary income when realized.

[104] U.S. Department of the Treasury, vol. 1, (1984), 147, and personal knowledge of the author.

[105] Treasury I adopted the controversial alternative of indexing basis starting in 1965. Under at least one current proposal, indexing would begin with 1913 values.

[106] Ginsberg (1990) notes that the ABA Section on Taxation concluded in a 1989 report that the 1986 elimination of the capital-gain preference has resulted in significant transactional simplification.

[107] Handler (1987), 1264.

[108] See Simon (1989) and references cited there.

[109] A contrary view, expressed, for example, in Kies (1987), is that the increased use of pass-through entities will lead to limitations on this form of pass-through vehicle.

[110] Kies (1987) identifies measures to improve compliance as a possible source of additional revenues following the 1986 act.

[111] On the need for a new international tax order, see Bird (1988).

[112] See Shuman (1984), 114-25, for a brief historical sketch of the development of the procedures and practices of the House Ways and Means and Senate Finance Committees. The classic treatment of the Ways and Means Committee, now quite dated, is Manley (1970).

[113] This topic is considered only briefly, because it is the subject of another paper for this conference. The present discussion draws heavily on Rudder (1983), (1985), and (1989). See also Witte (1985), 238-43 and chapter 15; Reese (1979); Surrey (1981), 185-86, and 196-97; McDaniel (1979), 522-28; and Strahan (1987) and (forthcoming, 1990). For a catalog of the abuses in the Ways and Means Committee and the Senate Finance Committee that contributed to the reform movement, see Spohn and McCollum (1975).

[114] Rudder (1983), 199.

[115] Rudder (1983), 197.

[116] See, for example, the descriptions of "Gucci Gulch" in Birnbaum and Murray (1987), 3-4.

[117] See, generally, Rudder (1983), 200-201.

[118] On the origin of this term, see Shuman (1984), 122-24.

[119] McDaniel (1979), 542.

[120] This discussion draws heavily on Rudder (1983), (1985), and (1989); see also Reese (1979); Witte (1985), 238-43; and Strahan (forthcoming, 1990).

[121] Surrey (1981), 185. He adds, "Thus, open markup sessions' designed to flood the committee process with sunlight only flooded the committee rooms with business lobbyists."

[122] Rudder (1983), 196 and 201-3. Witte (1985), 241, has noted that advocacy of the good-government reforms depended on three questionable assumptions: that the public cares about narrow tax benefits of others, that they would care enough to follow complicated and tedious Congressional tax proceedings (or expect their representative to do so), and that they would express their displeasure with such benefits to their representatives, who would vote accordingly.

[123] Rudder (1983), 210-11 notes that limitations on spending (e.g., prohibiting the issuance of regulations) are sometimes used to circumvent House restrictions on placing tax-related amendments in appropriations bills.

[124] Witte (1985) surveys the history of U.S. income-tax policy through the 1981 act. On the growth of tax expenditures, see chapter 13.

[125] Rudder (1983), 208-13 and (1985), 211-212, emphasize these points.

[126] Reese (1979), 249-50.

[127] Birnbaum and Murray (1987), 275, describe a public attack by Packwood on JCT Chief of Staff Brockway, which they characterize as "cruel and mindless."

[128] Reese (1979), 250.

[129] Witte (1985), chapter 11, provides a detailed description of the bidding war that led to the excessive tax cuts of 1981. On this episode, see also Rudder (1983), 205-6, and Shuman (1984), 264-68.

[130] Rudder (1983), 206.

[131] Witte (1985), 242, has argued, "Once the position of the chairmen was weakened and the power to add tax provisions was spread out over many centers of influence, trade-offs and even judicious restraint became very difficult, as the only power available to the chairmen was the power to create policy packages that outbid whatever competing combinations were proposed elsewhere."

[132] See, generally, Rudder (1983), 206-8. On the role of the Budget Act, see Rudder (1985), 217.

[133] Rudder (1983), 207. The germaneness rule was applicable because the tax bill was a reconciliation bill under the Congressional Budget Impoundment and Control Act of 1974.

[134] Rudder (1989), 232.

[135] Rudder (1983), 207.

[136] Rudder (1983), 207-8.

[137] Witte (1989). Simon (1989) has expressed a similar view: "...It would be disingenuous to suggest that the public has as much impact on the legislative outcome under the current tax legislative procedures as the lobbyists and their clients do."

[138] Rudder (1985), 218. Strahan (1990) has also noted a return to the practice of choosing new members from relatively safe districts: "Since 1981 neither party has appointed a member who has won less than sixty percent of the vote in the previous election."

[139] Witte (1989) has argued, "Tax reform is most likely to be successful the more insulated the political process is from public pressures. This applies to actions in both Treasury and in Congress." Though little noticed (except, for example, by Witte, [1989]), it is worth noting that some of the same techniques used by Rostenkowski and Packwood were used in the preparation of Treasury I. Treasury Secretary Donald Regan met with only a small group of high-level political appointees to discuss the proposals, which were not shared even with the White House until after they had been finalized. Besides allowing the President to distance himself from the proposals if they should prove to be politically unacceptable, this strategy minimized the possibility that the reform package would be leaked by members of the White House staff unsympathetic to tax reform and picked to pieces. On this, see Birnbaum and Murray (1987), chapter 3.

[140] Another important ploy was utilized by Rostenkowski in dealing with the Ways and Means Committee; beginning debate from a set of "staff options" (subsequently identified as "Rostenkowski's plan") rather than from current law meant that tie votes resulted in approval of proposed changes, rather than retention of current law. See Birnbaum and Murray (1987), 123-24. In effect the same strategy was used in the Senate Finance Committee, once Packwood developed the "27% solution."

[141] Birnbaum and Murray (1987), 161-75, 237, and 253-83, noted by Verdier (1988).

[142] Witte (1989).

[143] Quoted in Birnbaum and Murray (1987), 260.

[144] Quoted in Strahan (forthcoming, 1990), chapter 7.

[145] Birnbaum and Murray (1987), 229, 237. Rudder (1989), 242, calls the requirement of revenue neutrality a "critical parameter." This brief discussion is not intended to be a comprehensive explanation of why and how the Tax Reform Act of 1986 became law, despite all odds. On that topic, including the use of techniques devised to overcome the limitations of the good-government reforms, see, for example, Birnbaum and Murray (1987), Verdier (1988), Witte (1989), Conlan, Beam, and Wrightson (1989), and Strahan (forthcoming, 1990) and sources cited therein.

[146] Verdier (1988) notes the observation by Congressman Barney Frank (D-Mass.) that these rules help members make the transition from voting No to voting Yes.

[147] Bittker (1987), 50, quoted in Doernberg and McChesney (1987), 903, note 61. According to Witte (1989), there were 682 transition rules. For a nearly complete list of transition rules identifying both beneficiaries and estimated revenue costs, see "Conference Agreement Transition Rules and Beneficiaries," 1986. Birnbaum and Murray (1987), 240, note, "The mere volume of these special handouts in the Senate alone also was unique at

a staggering $5.5 billion." Official estimates of the cost of transition rules in the final Act place the figure at somewhat in excess of $10 billion.

[148] Birnbaum and Murray (1987), 240. Birnbaum and Murray, (241), cite the following examples of specifically targeted transition rules: "an automobile manufacturer that was incorporated in Delaware on October 13, 1916" (General Motors) and "a mass-commuting facility that provides access to an international airport" (Dulles).

[149] Simon (1989)

[150] Handler (1987), 1263)

[151] Handler (1987), 1262.

[152] Handler (1987), 1263.

[153] Quoted in *Federal Tax Association* (1988), 1583.

[154] Handler (1987), 1266.

[155] These figures are cited by Merrill, Collender, and Cook (1989).

[156] Strahan (forthcoming, 1990), chapter 7.

[157] Leonard (1988), 974. In a similar vein, Chapoton (1990) writes, "..presently the joint Committee Staff, like the other staffs, is very restricted in its latitude for simplification, given the need to maximize the revenue impact of virtually all amendments with which it is presented."

[158] Leonard (1988), 978.

[159] Budget of the United States Government. Fiscal Year 1990, 4-4.

[160] Federal Bar Association (1988), 1583.

[161] Bob Shapiro, former Chief of Staff of the Joint Committee on Taxation, has noted that in the 1960s revenue estimates were not even made until the committees had made their decisions; they were not even mentioned in markup. See "Panel Discussion" (1979), 274, quoted in Federal Bar Association (1988), 1582.

[162] Teuber (1986b), 882.

[163] Teuber (1986a), 699.

[164] Handler, (1987), 1263-4.

[165] Simons (1988), 633.

[166] Thus, for example, whether the measurement of income should be adjusted for inflation would depend on the expected rate of inflation, the ability of the private sector and the IRS to deal with inflation adjustment, and the harm to equity and economic efficiency that would result from not adjusting for inflation.

[167] As section III should make clear, the author is not a fan of tax expenditures. But the Congress is. Given that, one can hardly argue with Simon's assertion ([1988], 627) that "the integration of tax lawmaking into the budget process is appropriate." This is not the place to discuss how the level and nature of tax expenditures should be determined. On this, see Surrey (1973) and Surrey and McDaniel (1985) and references therein.

[168] A decision might, of course, be made to raise additional revenues from sources other than the income tax. This complication is not considered further.

[169] On the role and present practice of revenue estimators, see Teuber (1986a) and (1986b). This issue is not pursued further in this paper.

[170] Thus Merrill, Collender, and Cook (1989), writing about the results of a revenue-driven process, have noted, "Traditional tax policy objectives, such as equity and efficiency, may not have suffered." I am tempted to quote David Brockway's eloquent comments on this part of an earlier draft; I will, however, defer to him in his role as a discussant.

[171] This discussion reflects correspondence with James Verdier.

[172] Verdier, in correspondence with the author, notes, "E.E. Schattsneider's political science classic, The Semi-Sovereign People...notes that much political conflict can best be understood as an effort by each side to widen or narrow the scope of conflict in ways that serve its particular interests. ... What the budget process has done in the 1980s is to force tax policy repeatedly onto the legislative agenda, and always in a context in which revenue-raising concerns dominate all others."

[173] In a comparative analysis of tax policy in Sweden, the United Kingdom, and the United States, Steinmo (1989), 505, 510, 511, and 515, has made the following observations:

> [O]ne of the major distinguishing characteristics of the American tax system is the huge number and amount of tax expenditures that complicate the tax code. ... [N]o other tax system comes close to being as particularistic and as complex. ... The U.S. tax system is not littered with these special amendments because tax policy makers feel that it is a good way to write tax law. ... Madison's fragmented institutions provide a profoundly important variable for explaining the complexity, low revenue yield, and ultimately the distribution of effective tax in the United States. The diffusion of political authority and responsibility, and consequent openness to particularistic demands, has encouraged policy activists to pursue their objectives via narrow interest group organizations and to define their objectives as narrowly as possible. Lacking central authority to which to defer, politicians are uniquely vulnerable to

these particularistic demands. Since no one is in control, accountability is missing, and it becomes nearly impossible for politicians, interest groups, and bureaucrats to pursue long-range objectives.

While one might agree with Steinmo's basic premise about why tax expenditures are enacted in the United States, it should be noted that the tax laws of foreign countries are not as lily white as he seems to believe; see McDaniel and Surrey (1985).

[174] Thus it stops short of considering such unlikely changes in the method of governance as adopting a parliamentary system of the type found in the United Kingdom. It is, however, worth noting the conclusion of Steinmo (1989) that tax policy is subject to much greater swings and to greater incoherence (but not complexity) in the United Kingdom than in either the United States or Sweden.

[175] Rudder (1983), 213. This softens the apparently contradictory view expressed by Rudder in the immediately preceding paragraph, "Rules and procedures are no substitute for political will. If members have no desire to preserve the integrity of the tax code, it is unlikely that procedural changes would measurably improve the situation." Improved rules and procedures may force somewhat greater responsibility. Writing in 1983, Rudder (213-16) seems to overstate the power of the 1974

Budget Act as "a new source of responsibility." She focuses primarily on the amount of revenue raised under the gun of reconciliation and the advantage of forcing members to make "specific trade-offs between one tax expenditure and another," to the virtual exclusion of consideration of the complexity of the resulting legislation.

[176] For a similar proposal, see Shapiro (1990). For a contrary view, see Mattson (1990), who argues, "To require simplification to be directly tied into a revenue-raising bill has the result of being 'ground-ruled' into complexity. Simplification then becomes merely a stalking horse for a tax increase."

[177] Handler (1987), 1267.

[178] One commentator on an earlier draft of this paper has expressed this as follows: "[T]he need for additional revenue (and the prohibition against raising rates) has forced legislators to adopt reforms they never would have considered otherwise. After all, the tax base was eroded during years when the Congress paid little or no attention to revenue effects of tax provisions. I do not think we would have had the base broadening that has occurred during the 1980s without the budget crunch."

[179] Witte (1986), 381.

[180] Simon (1989).

[181] We do not consider proposals that bipartisan commissions be employed to bring rationality to the process of formulating tax policy. See, however, Reese (1986). Such

proposals seem to be aimed primarily at the achievement of substantive reform, rather than simplification, per se.

[182] Chapoton (1990).

[183] In this regard it is instructive to quote from *Federalist 10*: "The apportionment of taxes on the various descriptions of property is an act which seems to require the most exact impartiality." (Quoted in Steinmo [1989], 511.)

[184] Simon (1989).

[185] On this question, see the insightful discussion by Surrey (1970).

[186] Recent experience at the Department of Housing and Urban Development is also worth remembering.

[187] John Nolan noted at the AICPA/ABA conference on simplification that the Office of Industrial Economics was not able to withstand such pressure under the Asset Depreciation Range System.

[188] Chapoton (1990). See also Hickman's comments on Chapoton's paper for the same point.

[189] See Doernberg and McChesney (1987a) and (1987b) for development of the view that members of the tax committees are essentially engaged in contracts with supporters for whom they attempt to gain favorable legislation.

[190] I am grateful to James Verdier for comments that outline the line of reasoning pursued in this subsection.

[191] This is not to say that I believe we will soon solve the deficit problem. The discussion that follows accepts the hypothesis that we may do so and examines its implications.

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COMMENT ON THE "BUDGET PROCESS AND TAX SIMPLIFICATION/COMPLICATION"

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Charlie McLure has covered a lot of ground in his stimulating paper. As he makes clear, the increase in income tax complexity has occurred simultaneously with several political trends. Among those are the breakdown of old political power organizations and the evolution of budgetary institutions and contexts. One can also impute, as Charlie does, various logical connections, if not causal ones, between the changing conditions (the revenue-neutrality constraint on tax bills, for example) and the complexity that has been generated. The paper led me to the conclusion, though, that there is no particularly compelling link in principle between the annual budget policy cycle and an increasingly complex tax law.

Indeed, Charlie's paradigm for the making of tax law is the persuasive reason the budgetary process per se (as opposed to the policies and capabilities of the people working through the process) cannot be blamed for the increasing complexity. His paradigm is the traditional reform ideal: First define the base, January 5, 1990; then determine the rates necessary to generate the required revenue. This concept apparently governed the 1986 tax reform to which he contributed so much. But in actual experience tax law is not shaped in this way. Rather, a peculiar reverse principle seems to apply: First set the rates, then define the base to generate the required revenue.

Charlie's description leads me to assign the blame for increasing complexity not on weaknesses in the budget process (in terms of its annual cycle, deficit limits, reconciliation,

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etc.) but on the inadequacy of the budgetary language. The "backwards" approach to tax policy that I have just described illustrates the inadequacy. To put the point in general terms, our budgetary language obliges us to work under constraints that are grossly incomplete as descriptions of the underlying reality.

In the instance of tax reform, the constraints took the form of prescribed tax rates. Such parameters taken by themselves impose no true economic limits, because they fall well short of specifying policy. But to accomplish the objectives of policy within such constraints-- let me call them "nominal" constraints--may require complex rules. For example, to increase revenue under a nominal constraint of a fixed schedule of rates, we must resort to "cats and dogs," to substitute effective rate increases for a simple adjustment of the nominal schedule.

Budget Director Darman's famous "looks like a duck, quacks like a duck" method of identifying taxes is a wonderful instance in the present context of what I am talking about. The problem is that ducks in the minds of the population or policymakers are not well-defined economic animals.

Let me illustrate the matter with my secret plan for eliminating the budget deficit without raising taxes and without jeopardizing any of our spending priorities.[1] Step 1 of the Bradford plan is to cut the weapons procurement appropriation to zero. Step 2, designed to offset any negative impact on defense readiness, calls for the enactment of a new "weapons supply tax credit" (WSTC). To qualify for the WSTC, manufacturers will sign appropriate documents prescribed by the secretary of defense and deliver to the appropriate depots weapons of specified characteristics (namely, those previously specified under procurement contracts). The WSTC might under other circumstances be thought of as payment for goods and services rendered, but in this case the amount of the credit can be used only in payment of income tax. Step 2 is, of course, a tax cut.

Taken by themselves, steps 1 and 2 result in equal cuts in spending and taxes. But a time of budget deficit is a time to be cutting spending while holding the line on taxes. Step 3 of the Bradford Plan, then, rounds out the tax program into a revenue-neutral "reform" by eliminating the taxation of interest receipts and the deductibility of interest payments (including cap health insurance and all social security benefits in the income tax) eliminating the deduction for state and local taxes for individuals, limiting benefit payments out of qualified retirement plans to $25,000 per year (with any excess subject to a penalty of 10 percent), and introducing a toll charge in lieu of dividend taxes on nondividend distributions by corporations. (Lest there be any doubt, all the details are made up.)

It is evident that the Bradford Plan, or something like it, would permit us to accomplish, in the guise of a program of apparent spending cuts and revenue-neutral tax reform, what we here would call a tax increase sufficient to eliminate the budget deficit. It may be thought that no one would be taken in by this budgetary slight of hand. But the basic logic of the plan is very close to what one sees in actual budget politics. Furthermore, I believe the description accurately conveys why the Bradford Plan, if actually implemented, would be recorded under existing budgetary conventions.

Note especially that steps 1 and 2 would change the budget numbers dramatically. The accounts would show a big cut in spending and a big cut in taxes. But the underlying economic reality would be absolutely unchanged. Everyone would be getting paid the same; the same weapons would be getting produced; the same programs would be going on in every real sense.

Arbitrariness between what is a spending program and what is a tax program is not confined to manipulations that leave the balance unchanged. As Kotlikoff[2] has shown, similar "relabeling" exercises can be devised to achieve any desired level of current budget deficits without implementing any real change.)

Everyone here will recognize my secret plan as the manipulation of "tax expenditures." Steps 1 and 2, for example, relabel the weapons program as a tax credit and thereby reduce both spending and taxes, but they leave the deficit unchanged. What has been labeled a revenue-neutral tax program most of us would regard as a tax increase in disguise. But where is the duck?

Charlie implies (page 33) that part of the solution to this problem is to sharpen the concept of tax expenditures. If what is meant is to refine the definition of the reference income tax against which tax expenditures are measured, I would disagree. I do not think there is an economically meaningful distinction between *tax* and *expenditure* programs as we now use these terms. What is needed is a more radical reform of our budgetary language.

We presently lack a budgetary language with clear, economic content. In no small part, this lack is due to the incomplete absorption into practice of what economists know about the equivalence of different transactions (for a simple example, lending and buying appreciating assets). The analysis is not easy even for those with training - - I would say the Treasury got the analysis wrong, for example, in favoring accelerated depreciation over investment credits as a way of offsetting the investment-discouraging effect of the income tax. The spread of sophisticated handling of economic ideas into the wider political process is sure to be slow.

Furthermore, beyond the areas in which there is, arguably, a body of knowledge waiting to be applied lies a huge region in which economic analysis is simply inconclusive. (Consider, for example, the debate over capital gains.) Nowhere is the lack of conclusions more severe than in the analysis of the incidence of government programs and rules. Budget policy ought to be about benefits and costs for people. But budget policy is just very hard to figure out, and therefore it is hard to specify constraints on policy in the form "Do good for this group and not too much bad for that group." Instead we say, "Don't touch the tax rates."

I am pessimistic about achieving sufficiently sophisticated and widespread knowledge to greatly change the situation in the foreseeable future. Instead, my positive suggestion would be to seek movement toward a system in which inadequacies of the income definition

will do less harm and in which complexity will be concentrated among fewer taxpayers. The program can be summarized by two operating principles: (1) Tax business (capital) income uniformly, and (2) tax business (capital) income at source.

Uniform taxation can greatly reduce the significance of legal form (basically because what is deducted by one taxpayer is included by another at the same tax rate), thereby rendering complexity less important. Uniform taxation of business income would permit adoption of the second principle, taxing business income at source. This principle, in effect, extends our traditional method of simplification: Drop taxpayers from the tax rolls. By drastically reducing the number of taxpayers who need to deal with complex tax rules, taxation at source would put the problem of tax law complexity into the same category as banking law complexity--a nuisance, perhaps costly, but not a threat to the social fabric.

These thoughts have been stimulated by Charlie's very good paper. I hope I will not be regarded as drifting too far from his text, and I look forward to our further discussion.

ENDNOTES

[1] In the following, I am borrowing freely from my 1988 paper "Tax Expenditures and the Problem of Accounting for Government," presented at the John Deutsch Conference on Tax Expenditures and Government Policy, Queen's University, Kingston, Ontario, November 17-18, 1988.

[2] Lawrence J. Kotlikoff, "The Deficit Is Not a Well-Defined Measure of Fiscal Policy," Science 241 (August 1988): 791-795.

COMMENT ON "THE BUDGET PROCESS AND TAX SIMPLIFICATION/COMPLICATION"

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Let me say that this whole experience here is somewhat surreal to me. The notion of attending a two-day conference of 250 tax professionals, probably the most influential tax professionals in the country, to discuss how to simplify the tax laws, I just find difficult to get my arms around, particularly looking out into the audience, where everybody has got his red button on to testify to his commitment to tax simplification. To me it is somewhat like going to a Hell's Angels conference to talk about the decline in social graces in America.

It was only last night at the speakers' dinner that our moderator told me that what we were supposed to talk about was not complexity in the tax law, but ways to get rid of it. That was somewhat surprising to me, knowing the players in the room.

My comments really aren't all that facetious. The fact of the matter is that to my view, the complexity of the tax system is not something that comes out of the ether somehow, and it does not exist because there are some wild and crazy people sitting around, thinking up ways of how to make the tax system more and more complex: At least outside the pension area, that is not an accurate description.

The reality is, I think, that we are the problem in this room. I don't just mean myself in my former role as chief of staff--Lord knows, if anybody has responsibility for the problem, certainly I share that--but I think each and every one of you out there is part of the problem. The reason for complexity in the tax system is that by and large it is a

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reflection of a variety of powerful, significant forces in our society, and those forces get expressed. The vehicle for having those forces reflected in the tax law is you. I don't mean to say that somebody just writes in a letter and says, "Make the system more complicated."

Rather, you all are coming to the Hill and saying, "Change the law to benefit me; simplify the law when it hurts someone else." But in my fifteen years up there, no one ever came to me that I can remember--perhaps some of you can correct me if I'm wrong--and said, "Really, you ought to simply the law in a way that adversely affects me or the interests that I represent." It doesn't surprise me. I mean, it would have been a little off-the-wall if you did. But that is the nature of how we get here.

And I don't mean that this pressure comes only from lobbyists for special interests. It also comes from tax reformers, people who feel that it is very important that we have horizontal and vertical equity in the tax system, that it accurately reflects income or whatever. By and large their bias also is to put those interests ahead of simplification when they conflict.

I think you can see my point just from looking at the papers prepared for this conference. Those writing papers from the business community talk about, "Well, we ought to get rid of those very complicated loophole closers that have been enacted in the last ten years; that's what the problem is." The tax reformers say, "Well, actually, the real problem is that we still have R&D credit out there or what have you," and that we could repeal those preferences, or we could get rid of the pass-through of losses through limited partnerships, and of those changes that would limit vast areas of complication. Everybody has just got a different view of how you do it. We all know how to simplify the law a great deal; each one of us could do it fairly easily. It's just that we'd all do it a different way, and the reason it doesn't get done is that we do have these different views, and none of us has a majority interest.

I personally think, in contrast to the impression you get from reading a lot of the conference papers, that these policy issues, in fact, are more important by and large than purely the interest in simplification. The primary tax policy concern to my mind is revenue. The whole notion that has come into vogue lately, that the problem we have is that all this recent tax legislation focuses on revenue, absolutely boggles my mind. Try and ask yourself what that process is about, what the tax law is about, if it is not to raise revenue. That's what the whole thing is about. It is not simply to come up with a variety of rules that tax advisors can all make our livings by. The purpose of the tax system actually is to raise revenue to fund the government, and that is the primary thing that the policy makers happen to be thinking about, and it is the primary thing that we all think about. There is probably no one in this room who thinks that simplification is more important than revenue, because you can obviously accomplish total simplification by repealing all taxes. Actually, last night at the speakers' dinner I saw Norman Ture, and if he's here then maybe it's not 100 percent, but by and large, I think that it would be the shared view that at least to some extent, revenue is more important than simplification. Most people in the room also share the view that horizontal and vertical equity are more important. Bob Shapiro points out that you can raise the same amount of tax in the very simple way of having a head tax. That has been discussed for many years in the literature as a very simple way of raising

revenue. Nevertheless, I think that virtually everybody would reject that as an approach to the issue. Economists by nature will tell you that the way you can simplify the whole tax system is to have a consumption tax. I don't really think that is going to happen. The people who oppose shifting to a consumption tax understand it may be less complicated than an income tax, but their real concern is the distributional effect, and they think that that is a more serious issue than simplification. Or they may oppose arguably simpler consumption taxes just because of their general unpopularity with the voters, who, after all, do have some say, and, appropriately, should have some say, in how we ought to structure our tax system.

A lot of you strongly hold the view that having the tax system promote savings and investment, promote low-income housing, or whatever other social cause you can think of, and so on and so forth, are, on balance, more important goals than simplification. You can't explain the various provisions we have in the law any other way. You cannot, for example, say that the R&D credit is simple; it clearly is not.

You've got to think of the whole issue of tax simplification in the context of those overriding policy goals. Beyond that, I think that a certain amount of the complexity is irreducible, assuming we are going to live with the income tax system, which is my basic assumption. We have a complex society, as Charlie points out in his paper. The transactions that people engage in are very complex; they are far more sophisticated than they used to be. The tax law naturally has followed that trend. In every other profession in the business community, life is becoming far more specialized; it is perfectly natural that the tax profession would as well. The tax law has been around for sixty-five years. Knowledge is basically cumulative. You set up one set of rules, and people understand those rules and figure out ways to operate around them so the rules have a different impact than was originally intended. As a result, the laws have to be continuously amended. They get more and more sophisticated, and people start to specialize. In the same way, science gets more and more sophisticated, mathematics gets more and more sophisticated: It is the natural state of affairs and not one that we can do much about.

Also, as Charlie points out, our society is very complex. Different people think we ought to have different things--they have different self-interests, and even when they do have similar self-interests, they often have different views about what our public policy ought to be. In our form of government, those diverse views are reflected through a competition of factions that leads, through our democratic process, to sets of rules that are not totally coherent. It is very difficult for one viewpoint to command the field.

That is a trade-off we make, and to my mind it is a fairly decent trade-off. I am much less troubled than Charlie indicates in his paper that he is, and a lot of other people appear to be, that we do have internally inconsistent provisions in the tax law. The notion that the policy makers are schizophrenic, I just think, totally misunderstands what is going on.

It isn't that the same guy is sitting there, saying, "Well, gee, I'd like to have fast write-off for something, and I'd also like to have the minimum tax." These are different people; they are different interests. There is one group that says, "I want to have this tax benefit,"

and there is another group that says the tax benefit is a lousy idea. They either have to compromise and come out with something that is in between and sometimes internally inconsistent, or there is a shift in relative power from time to time, so that one has the upper hand, and, at other times, another has the upper hand. But you can't expect the political process to have a uniform view and set of rules when the society that it is reflecting doesn't share that uniformity.

Having said that, I think simplification of the tax law is an important goal. I think that it is impossible to look at the tax law and not come to the conclusion that it is extraordinarily complex and also that there are many areas where you can simplify the rules. It may be reaching a point that a number of people have talked about where the complexity of the whole system is overwhelming both the government and the taxpayers. I share that concern, and it may be that after we have had this major shift in the eighties of who ends up paying the tax, which is the really big question, how you cut up the pie, that people may have accepted this change in the relative burden of the taxes, and now we can turn to a period of consolidation and perhaps smooth out some of the edges.

To do that, though, to get some simplification, don't think that it is merely some technical exercise. There are some areas where we can make some changes that nobody particularly cares about but that are important changes, and changes along these lines have been going on for some time. The projects last year on rationalizing the penalty rules and the minimum tax are examples. Projects such as these have been going on for years, instituted both as a result of interest of outside groups or self-starters on the Hill or self-starters in the Treasury and IRS. A lot more can be done. The more people view simplification it as an important issue, the more that will be done, and I think that is an important thing to accomplish.

But to get major simplification, somebody is going to get hurt, and somebody is going to get helped. You can't get around that fact. Most simplification of any significance is going to have a substantive impact, and people are going to fight heavily about it, and in order to get it, you all are going to have to be willing to compromise on some of your substantive desires.

A few comments on Charlie's paper more directly: First, I personally don't share the view that the budget process has a great deal to do with the increasing complexity of the tax system or that the language of the Budget Act or, indeed, even the size of the deficit itself has much to do with it. I think that a certain amount of the revenue-driven legislation has increased the complexity of the tax law, and a certain amount of it has decreased it. Where the balance comes out, I don't know. I don't think anybody has done a very disciplined analysis of the question or looked through the legislation in the last decade to assess the overall balance or to determine the extent to which the items that are complications really don't have much to do with the budget process. Section 89, I think, is a good example of a complex provision that was not driven by the budget process. You could fight about the policy, but it is not a revenue issue.

Charlie's paper, I think, is--if you haven't read it, you ought to read it--a great discussion of the tax legislative process, of the development of the budget process, and of

the nature of complication of the tax laws and a number of other issues. From my view, the principal failing of the paper comes when he had to follow the instructions of the moderator and tie together the two issues of the budget process and the complication of the tax laws, because I think that the relationship is fairly tangential.

I certainly don't think that you will have these overall changes in the political process that Charlie recommends and that would take the legislative process away from Congress. I personally don't think that would be a very sensible idea. But in any event, I don't think it is realistic to assume that it will happen. I personally would vigorously oppose the notion of attempting to accomplish simplification by providing in the budget process that in order to satisfy the revenue target, the legislation can't modify the base of the tax system but can only increase tax rates. I think that that would be a policy disaster, and I think there is zero evidence that that would increase the simplification of the tax law. That is like saying that in the 1960s and 1970s, the tax law got simpler rather than more complicated. That just simply is not true. In any event, I think that proposal is unlikely to be adopted.

I do generally support the notion that a lot of things can be delegated to Treasury. Keep in mind, however, that a common criticism of recent legislation is that too much has been delegated. Certainly some areas, indeed the one that Charlie cites on tuxedos, in fact were delegated to the Treasury Department. Treasury was supposed to go out and provide depreciable lives for assets. That was something that staff tried very hard to have done; we got it into the legislation, and it was stripped out in 1988, I guess. But it wasn't stripped out by staff saying,"Look, let's complicate the tax system," or, "Let's take authority away from Treasury." They wanted to send it down there. It was taken out because there were interests out there that were affected, whether it was the noncommercial aircraft or formal wear industries, whoever cared about it--they were the ones that wanted it out of the system because they were worried about what Treasury was going to do. They were worried that simplification might have increased their taxes.

As the final point, I think that it is unrealistic to look at any one party for the solution--to look solely at Treasury, the IRS, or the Joint Committee. Certainly, I think it is a very big mistake to think solely of the Joint Committee staff as opposed to the Hill staff generally. I think that all of them, historically, worked actively together on this, and they are going to continue to work on it. Everybody out here can push towards giving simplification a greater significance. My hope is that those who get involved in the effort try to work in bits and pieces rather than trying to do it all in one fell swoop. I do think you can accomplish some simplification in the tax law, and I think that the test you face really is whether that is your principal goal rather than using the banner of simplification to accomplish some substantive political objective that you might have, in which event I think that seeing much simplification occur is relatively less likely.

THE ROLE OF THE TREASURY DEPARTMENT IN REDUCING TAX COMPLEXITY

JOHN E. CHAPOTON*

No one would argue with the proposition that the tax system is complex. The question is whether the tax system is unnecessarily complex. Most people--taxpayers and tax experts alike--would answer that question with a resounding yes.

Unanimity begins to dissipate, however, when one seeks the definition of *tax complexity*, much less its causes, and views diverge widely when realistic solutions are sought.

One solution uniformly advanced is a reduction in the frequency of tax legislation. Without question, even the most complicated tax provision becomes more "simple" over time; if it remains on the books unchanged, taxpayers and their advisers learn the meaning of the provision and how it will be applied by the government. There is great truth in the expression "An old tax is a good tax." Those responsible for tax legislation should be often reminded that by continually amending the Code, they are adding immeasurably to its complexity. For the purposes of this paper, however, it is assumed that the forces causing increasingly frequent tax legislation are beyond the influence of tax professionals who can be expected to become familiar with the ideas generated by this conference and the contents of this paper.

There are many causes of tax complexity beyond the frequency of legislation, and tax professionals both in and out of government, if they are motivated, can strike a blow against these factors. This paper is an attempt to demonstrate how tax professionals in the U.S. Department of Treasury can make a significant contribution toward reduction of tax complexity. In my view, the Treasury's Office of Tax Policy (OTP) offers the greatest hope for meaningful simplification in the tax system.

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DEFINITION OF COMPLEXITY

Ward Hussey has defined a simple tax provision as one that is not hard to understand in the abstract and is not hard to apply.[1] He defines complex as the opposite. This is probably the best general definition of complexity, and it is helpful to keep this straightforward, two-pronged definition in mind. It is necessary for the purposes of this paper, however, to be more specific and to attempt to recognize the different meanings of complexity for different levels of taxpayers and tax professionals.

Level 1 Complexity

For taxpayers who are not self-employed, have no investments that raise tax complexities, do not itemize deductions, and have no unusual events during the taxable year (such as the sale of a home, a divorce, an employment-related move or retirement), the tax system really is not unduly complex. Admittedly, to the taxpayer who confronts it once a year, the income tax return is still a formidable document.

Nevertheless, it is not unreasonable to expect such a taxpayer to be able to complete his own return, reporting his wages and relatively small amounts of interest and perhaps dividend income. Completion of the form is not a pleasant chore, even for this type of return, but with repetition it can become a relatively simple task (complicated, of course, by changes in the law, which require changes in the forms). For purposes of this discussion, complexity with respect to these taxpayers who might reasonably be expected to complete their own tax returns will be referred to as "level 1" complexity.

Level 2 Complexity

For taxpayers who itemize deductions, invest in partnerships, or have unusual tax events during the year (excessive medical expenses, casualty losses, a sale of property, the necessity of claiming an income tax credit, etc.) the tax system becomes considerably more complex. If the taxpayer is self-employed, the level of complexity is increased significantly. For such taxpayers some understanding of income tax jargon and concepts is required to gather the proper information and compute taxable income and tax liability for the year. Complexity with respect to these taxpayers will be referred to as "Level 2" complexity.

Government officials developing legislation, regulations, and the income tax forms to be used by taxpayers facing this degree of complexity may reasonably assume that such taxpayers will receive some professional assistance in completing their income tax return. It is important to note, however, that the overwhelming majority of taxpayers who address level 2 complexities generally do not engage in any substantive tax planning. They rarely engage in, or refrain from engaging in, a particular transaction or activity because of the tax consequences, or tax uncertainty, it presents; tax complexity for them is primarily the difficulty of accounting to the government after the fact.

Level 3 Complexity

Taxpayers who seek tax assistance in planning business, financial, and personal transactions and events--which includes most medium-sized and large business taxpayers--face an entirely different type of complexity in the tax system. For such taxpayers, complexity means either lack of certainty in the tax rules or that a satisfactory level of certainty can be achieved only at excessive cost. For such taxpayers the significant problem is ascertaining the rules of the game in advance with an acceptable degree of certainty and at a reasonable cost. Where the rules are not clear, or can be determined only by time-consuming and expensive professional assistance, the rules are said to be too "complex." Tax complexity facing this most sophisticated category of taxpayers is referred to in this discussion as "level 3" complexity.

It is obvious that virtually all anti-abuse amendments to the Code are aimed at level 3 taxpayers, those who seek advice before engaging in a transaction. Unfortunately, few of the anti-abuse provisions we have seen adopted over the last several years successfully employ any technique to limit their scope to this category of taxpayers, thus imposing unnecessary complexity on other levels of taxpayers.

SOURCES OF COMPLEXITY IN THE TAX LEGISLATIVE PROCESS

All of us who have worked with the tax legislative and regulatory process can point an accusing finger at a number of factors inherent in the process that contribute to its confusing state. I would list the following.

Frequency of Legislation

As discussed earlier, too much tax legislation enacted too often is clearly a major enemy in the war against complexity; unfortunately, this factor is also beyond the influence of the audience to which this paper is directed.

Speed of the Legislative Process

The orderly tax legislative process that existed in the 1960s and into the 1970s has been replaced with a chaotic system that often adopts major changes overnight with no opportunity for thoughtful analysis or input from professional groups or academia and little time for the staffs to consider all of the ramifications of the changes. Errors are inevitable in such a process, and the thought and time required to reduce complexity is a luxury that is simply not available.

Lack of Effort

The tax professionals involved in the legislative process do not expend meaningful effort to seek simpler concepts and rules as new legislation is developed. Staff devotion is to conceptual purity and breadth over ease of comprehension and application, with the following results:

1. New concepts and new rules are devised when existing provisions might be utilized. Time constraints do not permit those who have the technical abilities to complete a thorough analysis of the consequences of adoption of a new concept.

2. There is little effort to confine the scope of a new provision, often because of concerns that such limitations would necessarily be arbitrary and thus conceptually unsupportable or that the limitations might miss the mark, excluding some taxpayers who should be included.

Lack of a Constituency

There is generally no constituency for simplicity in the tax legislative process. It does not exist to any meaningful degree at the elected-official level, the appointed-official level, or the staff level. Each of the parties involved in the legislative and regulatory process must respond to other demands (increased revenue, political considerations, correctness, prevention of abuse, etc.) that override any concern for the complexity caused by a particular proposal.

Diffusion of Responsibility

The legislative process diffuses responsibility for the adoption of new, complex rules among a number of offices within the government. The result is that no single office or individual is charged with, or accepts accountability for, the complexity of tax legislation.

Impact on Tax Forms Ignored

Insufficient time is devoted during the development of new concepts and rules to the impact of such changes on the income tax forms and on the individual taxpayers or professionals who must complete the forms.

Revenue

Since 1981 an overriding consideration in any tax legislation has been its impact on federal revenues. The need to maximize revenues from complex, technical changes has

tended to expand the breadth of such changes, and the need to minimize revenue loss in correcting policy errors has prevented or limited corrective action.

It would be difficult to obtain a consensus on the relative amount of blame to be accorded these factors, but I believe most tax professionals would agree that each of the factors listed (and others that could be added) is a significant contributor to complexity in the tax system. Since all of these factors with the exception of the first two--frequency of tax legislation and speed of the legislative process--are to some degree within the control of tax professionals (in and out of government), there is certainly reason to think that complexity could be reduced if these flaws in the process were seriously addressed.

These flaws will not be dealt with in a meaningful way, however, unless individuals having leadership roles in the process are motivated to implement changes to reduce tax complexity. Like the weather, everyone in the tax business talks about complexity, but no one does anything about it. No one in a position to take steps to change the process is motivated to do so. It is submitted that lack of motivation is due in large part to the absence of accountability for complexity.

It is the premise of this paper that responsibility for minimizing complexity should be fixed on the OTP in the Treasury Department. The basis for that conclusion, together with suggested changes that could be adopted by the OTP to address the causes of tax complexity, is the subject of this paper.

TREASURY'S OFFICE OF TAX POLICY SHOULD ACCEPT RESPONSIBILITY FOR REDUCING INCOME TAX COMPLEXITY

It is obvious that the OTP plays a key role in the tax legislative process. On the specific subject of reducing income tax complexity, however, its role is--or should be--pivotal. The other participants in the legislative process lack either sufficient interest in simplification or sufficient influence over the process.

Members of the Tax-Writing Committees

Congressmen and senators on the tax-writing committees can quite properly be criticized for the frequency of tax legislation, the speed of the legislative process, and the tremendous complexity these factors impose on the tax system for all levels of taxpayers. Additional publicity about the complexity and confusion resulting from frequent tax legislation would certainly be desirable and might stem the tide eventually. It is not correct, however, to indict the members of the tax-writing committees for the internal complexity of the rules they adopt. The members should and must rely on their staffs with respect to technical matters, and reducing complexity is a technical undertaking.

Members cannot realistically be expected to react to the complexity problem in a meaningful way unless and until it becomes a political issue accompanied by some political accountability. If that were to occur, which seems unlikely at present, the members would be motivated to direct their staffs to produce less complex provisions even at the cost of more arbitrary and less comprehensive rules; such instructions would contribute significantly to simplification. It is not within the power of the tax professionals to whom this paper is addressed to bring about such a change, however.

The tax staffs of individual members should be classified for these purposes with the members they serve. They are often very competent technicians and thus may have the ability to address complexity issues, but their first duty is to carry out the specific goals of their members, and as indicated, simplification will not be one of those primary goals.

Tax-Writing Staffs

The House Ways and Means Committee and the Senate Finance Committee are each served by very able technical tax staffs who develop legislative proposals of interest to their members. These staffs must be regarded as partially responsible for unnecessarily complex tax laws. It is difficult, however, to place primary responsibility here; they, like the personal tax staffs of individual members, must first serve the views of the committee members (particularly the committee chairman or ranking member, as the case may be), and thus considerations will be imposed upon them that will outweigh concerns for complexity.[2]

Joint Committee Staff

The Joint Committee staff is clearly a responsible participant in the creation of tax complexity. Indeed one might argue that this staff and its chief of staff bear almost equal responsibility with the Treasury's OTP for failure to alter complex amendments and to implement changes in its procedures to foster simplification. However, unlike the Assistant Secretary for Tax Policy, the chief of staff functions more as a staff member than as a principal in the legislative process; consequently, he is less able to initiate or insist upon action that would reduce complexity. In addition, the Joint Committee staff, like the other staffs, is very restricted in its latitude for simplification, given the need to maximize the revenue impact of virtually all tax amendments with which it is presented.[3]

Private Sector Tax Professionals

Members of the tax bar and the tax accounting profession in the private sector can make significant, though less direct, contributions toward combating complexity in the tax law. They have the technical ability to identify complexity and to develop solutions or avoidance techniques. Unfortunately, the speed of the tax legislative process over the last decade has made it difficult for private sector tax professionals to have a meaningful impact, especially since they often do not see statutory language until the legislative process is almost completed.

Probably the most meaningful contribution private sector tax professionals can make is to identify particular existing areas of unnecessary complexity and suggest solutions, thus increasing awareness of specific problems. On a more comprehensive basis, conferences such as this can obviously suggest substantive solutions for review by government tax professionals and can spotlight process changes that should be considered.

Private tax professional groups should also continue to stress that complexity is exacerbated by the frequency of tax legislation, with the hope that taxpayer groups and individual taxpayers will begin to focus on that fact and communicate their objections in political terms to their elected representatives.

Tax Lobbyists

Although tax lobbyists are significant participants in the tax legislative process, they will not be motivated to address complexity issues. To be convinced of that, one need only conjure up the possibility of advising a client or company chairman that the legislative change sought was obtainable but it would have added too much complexity to the Internal Revenue Code.

Office of Tax Policy

Responsibility for addressing the complexity problem should be placed in the Treasury's OTP because of the limitations on the effectiveness of the other participants in tax legislation, if for no other reason. The Executive Branch, generally speaking, is expected, and has the capability, to initiate legislative changes. The Treasury Department certainly has the resources to analyze both the theoretical and practical impact of tax change simplification.

From the technical standpoint, the OTP plays a major role in the early stages of development of all tax legislation. This is obviously so with respect to proposals made by the Administration; however, even with respect to tax legislation initiated by individual congressmen and senators or the Joint Committee staff, Treasury's views are always sought informally and through the hearing process.

In addition, the Assistant Secretary for Tax Policy has almost complete independence in dealing with tax policy issues of a technical nature. No other office within the Executive Branch will have any significant interest in or influence over the type of technical policy issues that are raised by most efforts to reduce tax complexity. Thus no other office would likely express opposition to restrictions on legislative proposals intended to make the proposed legislation less complex. By the same token, no other office could be expected to initiate tax change simplification. In brief, responsibility falls on the Assistant Secretary for Tax Policy, since no one above him will have the necessary technical expertise or interest, and no one below him will have sufficient authority.

In addition, the OTP can, with the cooperation of the IRS, develop complete information on the impact of tax law changes on the forms, return preparers, and the administrative process of providing interpretative guidance through regulations, rulings, and announcements. The regulations process itself is the joint responsibility of the OTP and the IRS and is thus within the direct control of these offices for purposes of coordinating with the regulatory process the simplification of legislative changes.

It is submitted that this conference would be considered a success if we agreed on only one thing: Principal responsibility and accountability for reducing complexity in the tax system should be placed on the Assistant Secretary for Tax Policy. With accountability thus "publicly" pinpointed, the occupant of that office and his staff would feel the necessity of addressing complexity issues in the legislative process and in public forums. Public explanations of efforts to reduce complexity (or the failure to do so) would be subject to analysis and criticism by the tax community. The result would be that an important participant in the tax legislative process would be motivated to reduce complexity and, one hopes, complexity would gain an important constituency.

Recommended Actions to be Taken by The office of Tax Policy to Reduce Tax Complexity

Motivating the Assistant Secretary for Tax Policy institutionally to become seriously committed to reducing complexity is essential if the OTP is to carry the lead role in the simplification effort; as already indicated, that office must carry the lead role.

Designation of a "Simplification Czar"

Just as the responsibility among the participants in the legislative process should be focused on the Assistant Secretary, the responsibility for overseeing reduction of complexity within the OTP should be pinpointed. It is not sufficient for the concept of "simplicity" to be articulated as an office policy (but then have that effort diffused by making it the responsibility of individual staff members working on the various legislative projects in the office). History clearly teaches us that conceptual purity and comprehensiveness will win the hearts of the able individuals who develop technical policy rules; simpler, less precise rules will not as quickly capture their enthusiasm. Thus, responsibility for reducing complexity must be directly placed within the OTP, and it must be accompanied by authority sufficient to achieve its purpose.

It would not be necessary for the selected individual to be of a senior rank in the OTP, but it would be essential that he or she be an experienced tax professional who is well-respected within the OTP. The essential points are that the job of overseeing the simplification effort within OTP be made a prestigious one and that the effort not become an additional layer of bureaucracy. Ideally, the individual would be an energetic, well-respected tax professional who would also carry on other substantive projects within the OTP. The individual would need the full support of the Assistant Secretary and the Deputy Assistant Secretaries. Finally, it is probably essential that the individual be a lawyer rather than an economist because of the technical drafting skills needed.

Development of a "Hypothetical" Proposal for Reducing Complexity in the Existing Code

Under the direction of the simplification czar, who I shall refer to as the "director of simplification," the OTP should commence a "hypothetical" program for reducing complexity in the existing Internal Revenue Code. This program should not have the impossible goal of designing an entirely new and less complex Code; the magnitude of such a task would be overwhelming, the project would then be classified as a "study," and the entire program would be gradually nudged to the back burner. Instead, the hypothetical simplification program should focus on the development of techniques for simplifying specific areas of the existing Code. It should involve a substantial effort, requiring the OTP to commit meaningful resources to it. Moreover, the simplification program should be given full publicity outside of Treasury, including a public description of the specific proposals developed, except where they might cause political embarrassment for the administration then in office (which could have a decidedly negative effect on the entire effort).

The simplification program should be hypothetical only in the sense that no prior decision will have been made to proffer any of the proposals it develops as part of a Treasury legislative program. The OTP director of simplification and the staff working on this program should not be inhibited by political reality (or the lack thereof) or even by the revenue consequences of their simplification efforts. They should, however, have authority from the Assistant Secretary to seek and obtain estimates of the revenue impact of their proposal, because revenue information is a helpful analytical tool.

The purposes of this "hypothetical" program would be twofold:

1. Credibility. It should be designed to give the simplification effort intellectual credibility within the OTP, and the position of simplification director prestige. To accomplish that, it must be an intellectually challenging exercise and not just a bureaucratic drag on the tremendous demands already imposed on the staff in that office.

2. Development of simplification techniques. It should seek methods and techniques to reduce tax complexity in many contexts. In working on simplification proposals for portions of the existing Code, techniques will necessarily be developed that can be applied to future legislation.

A spin-off benefit of the program would be that the OTP would then have specific proposals on the shelf for simplification of the reviewed Code provisions should the opportunity, politically and fiscally, for reducing complexity be presented at some future date. This should not be regarded, however, as the primary purpose of the effort; the possibility of Treasury actually presenting significant simplification proposals as a package would be remote, since it would likely lose revenue and win few political friends. As mentioned, to impose political reality as a consideration would inhibit this effort.

With the stated purposes of this simplification program in mind, the first task of the program should be to develop (1) a plan specifying what areas of the Code will be

addressed initially and (2) a timetable for completion of the effort. The timetable should call for specific proposals not later than six months after the effort is initiated, so that a concrete work product will be in hand within a foreseeable time frame. (Additional projects can of course be added after completion of the first phase, but the important benefits from the hypothetical simplification program would come from the initial phase.) The effort should be specific and comprehensive with respect to the portions of the Code attacked, yielding detailed proposals for their simplification.

It is beyond the scope of this paper to discuss the substantive areas that should be addressed in this initial phase of the OTP's hypothetical simplification program. I would suggest, however, that a guide be the previously quoted principal, "An old tax is a good tax." There are certainly ample new tax provisions that many would regard as "bad" taxes if complexity were the test.

I would list the following areas as prime candidates for the hypothetical simplification project: the corporate alternative minimum tax, the passive activity loss rules, the uniform capitalization provisions, and the time-value-of-money rules (sections 483, 1271-1288, and 7872 of the Code).[4] Each of these sets of rules is complex to the point that serious doubt of raised that they can and will be applied properly and evenly by the Service. They epitomize the frequently expressed concern that the law intended by the Congress and the law applied in the field are different sets of rules.

Simplification Techniques

One direct benefit that could be expected from the hypothetical simplification program described previously would be the development of various techniques that could serve as a reservoir of ideas to be used in future simplification efforts. I will not discuss in detail the types of simplification techniques that might be considered in the OTP's simplification program, but a review of the literature on tax simplification clearly indicates that some techniques deserve consideration in the practical laboratory that the OTP's hypothetical program should represent.

In developing such techniques, it is important that Treasury bear in mind that complexity should be measured by reference to the taxpayers to whom the proposal is intended to apply. In that exercise, it is submitted that the focus should be on the levels used in defining complexity at the beginning of this paper.

With respect to level 1 complexity, the objective is to prevent, to the extent possible, level 1 individuals from becoming level 2 individuals (that is, those who will need professional assistance in preparing their returns). In that regard, it should be noted that level 1 complexity has been addressed with a considerable degree of success over the years. For example, the short Form 1040 (both 1040A and 1040EZ), increases in the standard deduction, reduction in allowable personal deductions, painstaking attempts to bring withholding as close as possible to actual tax liability, comprehensive third-party information reporting, and many other changes have contributed to a much simplified tax reporting and payment process for a substantial number of taxpayers. While frequent changes in the tax

laws are the main culprit for level 1 taxpayers, a constituency for level 1 simplification currently exists in the legislative process. This appears to be the result of the true "grassroots" concerns of our elected officials that the tax laws need to be simplified whenever possible for the vast majority of their constituents. Thus, it is submitted that level 1 complexity is generally not the principal problem we should be addressing.

Our main simplification efforts should be focused on level 2 and level 3 complexity. In this context simplification has two broad facets: Simplification is achieved to the extent that it is successful in preventing level 2 taxpayers and their return preparers from having to deal with complex provisions aimed at level 3 taxpayers; simplification is also achieved to the extent that it is successful in minimizing the costs to level 3 taxpayers of obtaining "certainty" with respect to the tax law treatment of their past and future dealings. The techniques described below (and others developed by Treasury as part of its "hypothetical" simplification program) can be used to address simplification within this framework.

Dollar Thresholds

The idea of dollar thresholds for anti-abuse or other restrictive rules is an established technique that is well suited for limiting level 2 complexity (that is, relieving level 2 taxpayers and their tax-return preparers from the burden of dealing with provisions aimed primarily at level 3 taxpayers). It appears, however, that in general, such thresholds have been too restrictive. The drafters have erred on the side of making the anti-abuse proposal more comprehensive. Just as important, these types of thresholds have usually been individualized to each specific Code section so that each must be separately learned, along with its limitations. For example, working through the "layered" exceptions for the applicability of the original issue discount rules of section 1272, versus the deferred payment rules of section 483, versus the below-market interest loan provisions of section 7872, is a feat in itself; but once learned, these exceptions are of no assistance in determining the applicability of other rules (such as the passive activity loss or at-risk rules) which have their own specific exceptions.

Consideration must be given to much more ambitious exclusions from such complicated anti-abuse rules. For example a high-dollar, per-transaction exclusion from all of the time-value-of-money provisions (sections 483, 1272, and 7872) could be provided without exception. In other circumstances where it is not appropriate to provide universal rules, it would seem appropriate, at a minimum, to present the threshold and other exceptions in a uniform fashion (that is, by placing such exceptions in the same place from section to section).

Another technique that should be considered is exclusion of a taxpayer from applicability of enumerated anti-abuse provisions of the Code based on the gross income of the taxpayer. For example, making many of the more complex provisions simply inapplicable with respect to taxpayers whose gross income does not exceed $75,000 would provide much needed certainty to the vast majority of taxpayers.

Such broad exclusions would, of course, reduce revenues, and that will always be a problem in today's budget-driven revenue packages. Such rules would also exclude some

taxpayers from the ambit of these anti-abuse provisions even though on an individual basis the particular taxpayer should be subjected to them (that is, it will make the rule less conceptually pure). Thus, there may also be some "psychological" cost to the extent such taxpayers would be thought to have beaten the system. All of those concerns, however, would seem outweighed by the understandability of these Code provisions that would result as they relate to the vast majority to taxpayers.

In addition, the application of many of the anti-abuse provisions should in concept be confined to taxpayers whose behavior can be affected (that is, primarily level 3 taxpayers), as contrasted with taxpayers who simply learn the rules (or whose tax return preparer learns the rules) at the end of the year when they are accounting for their activities in preparing their income tax returns. Anti-abuse rules should be directed toward taxpayers who engage in transactions, or who restructure transactions, to take advantage of benefits offered under the general tax rules; there is little reason in terms of policy for visiting the complexity that such rules represent on taxpayers who would not be expected to consult advisers in advance of a particular transaction. The better policy would be to exclude them, even if to do so means also excepting some other taxpayers who are engaging in such planning. To accomplish this would require thoughtful analysis of the particular abuse that is being addressed, so that exceptions and exclusions could be tailored to that particular provision. The objective in each instance, however, would be to provide bright-line rules excepting those taxpayers who would not be expected to engage in that type of tax planning.

"Horizonal" vs. "Vertical" Drafting

Ward Hussey has suggested that significant simplification could be obtained in the statute itself by the use of what he labeled "horizontal drafting."[5] He described chapter 1 of the Code as a typical example of "vertical drafting": One substantive area of the income tax laws is dealt with in depth in one subchapter. Matters relating to corporations are found in subchapter C, matters relating to estates and trusts in subchapter J, and matters relating to partnerships in subchapter K, even though many of the principles applying to these different types of taxable entities are the same. The principles are simply repeated, often with variations, in each of the subchapters. Mr. Hussey contrasted this with the horizontal treatment of administrative matters contained in subtitle F, where rules relating to assessments of deficiencies, interest on deficiencies, refunds, and similar administrative matters are set forth in one place, even though they apply across the boundaries of the income tax, the estate and gift taxes, and excise taxes and even though they apply to all types of taxpayers.

Mr. Hussey concluded that horizontal drafting would not only use fewer words in the statute but would also provide more consistent and predictable results by using established concepts and principles. The possibility of a new rule being developed for a particular type of taxpayer to achieve a purpose for which there is already an existing rule elsewhere in the Code would be avoided.

As an example, Mr. Hussey pointed to an amendment in the ninety-fourth Congress providing that for certain income and excise tax purposes Native American tribal

governments shall be treated as if they were states. Originally, this required amendments relating to Indian tribes in some twenty-two provisions of the Code. The final version of the legislation (H.R. 4089) utilized one generalized Code section (new section 7871), which was put in new subchapter C of chapter 80 (General Rules), entitled "Provisions Affecting More Than One Subtitle." Cross-references to the new section 7871 were added in the principal provisions of the Code affected by the legislation. He points out that as a result of this technique, understandability of twenty-one provisions of the Code as they apply to other than Indian tribes was not impaired.

It is worth noting that while new subchapter G is still in existence, the drafting approach it represents has not been widely used. Subchapter C now contains section 7872 (relating to the treatment of loans with below-market interest rates--the legislative response to the *Dickman* case) and section 7873 (relating to federal tax treatment of income derived by Indians by exercise of fishing rights). Certainly there have been more than two amendments since the ninety-fourth Congress that could have been properly included in a general provision affecting more than one subtitle.

The concept of horizontal drafting deserves closer attention than it has received since it was suggested by Mr. Hussey in 1978. Not only is it a drafting technique worthy of consideration in future legislation but, it also offers the hope of dramatic simplification if the substantive rules of the present Code could be altered to facilitate horizontal drafting. To take an extreme example, if all of the constructive ownership rules in the Code were resolved into a single set of rules, those rules could be stated in one place in the Code and would have to be learned and understood only once regardless of the type of entities that were being tested and regardless of the context in which the question of relationship might arise.

An even more dramatic proposal for this type of drafting technique would be the development of a new set of rules for pass-through entities. That is, the same tax rules would be applicable to partnerships, subchapter S corporations, real estate investment trusts, and similar entities. Although that is substantively a far-reaching and initially disruptive proposal, the simplification it could afford would be even more far-reaching. Not only would the Code be made considerably easier to read and understand, the number of rules taxpayers and their advisers would be required to learn would be significantly reduced. Perhaps most important, tax planning would be greatly simplified, since the choice of entity to be used in a particular transaction would be much less tax-sensitive.

Thus it can be seen that "horizontal" drafting could reduce both level 2 and level 3 complexity. Level 2 complexity could be reduced because the professional tax return preparer would be better able to address those events or circumstances that cause his client to require his assistance, without having to command a working knowledge of many different provisions and concepts. In addition, this type of drafting could greatly reduce level 3 complexity, since a taxpayer and his advisers in structuring future business transactions or dealings would not have to spend great amounts of time analyzing the disparate tax consequences that would result from different, though economically similar, arrangements.

The fact that a thorough tax analysis cannot be avoided in many instances should not deter us from attempting to eliminate or reduce that aspect of business planning where feasible. It seems obvious that a good-faith attempt at meaningful simplification of the tax laws would involve serious work toward Mr. Hussey's concept of horizontal drafting.

Institutional Changes

In addition to the development of the hypothetical simplification proposals and the substantive techniques to achieve simplification that would be derived from that program, the OTP should take steps to institutionalize the active role of the director of simplification in the legislative process. The objective would be to have the director involved at the right time in the development and presentation of a rule or concept, regardless of the genesis of the proposal or whether it concerns legislation, regulations, or both. Following are some of the steps that OTP should consider toward this end.

Adoption of OTP Simplification Policy for Future Legislation

The OTP simplification director should be given responsibility and accountability for reducing complexity in future legislation. He should have clear authority to require the staff people responsible for individual areas in which legislation is being considered to explain the complexity issues raised by a particular legislative proposal and why that complexity cannot be reduced. Again, it would be essential that the Assistant Secretary and the Deputy Assistant Secretaries fully support the authority of the simplification director to examine the complexity aspects of all developing legislative proposals and to require that simplifying modifications be made where appropriate. To that end, the simplification director should have the authority to obtain revenue estimates so he can present to the Assistant Secretary the revenue cost of simplification.

The director of simplification obviously must be given free rein to examine all active legislative efforts in the OTP. Again, great care should be taken that this exercise does not become simply another level of review; it should instead be an effort carried on by the staff people primarily responsible for the particular legislative proposals, with assistance from the simplification director. The result should be a careful analysis of the complexity that would be caused by each legislative proposal being developed in OTP and consideration of potentially simplifying alternatives. It should be made clear that the simplification director will be held accountable within the OTP if unnecessarily complex legislation is proposed. Thus, it will often (but not always) be advisable for the simplification director to provide a memorandum to accompany a legislative proposal documenting the factors that made greater simplification impossible. Such factors might include the following: the revenue cost was too great, the required changes were politically unacceptable, or even time constraints precluded the required analysis. It would be important to show, however, that the effort had not been ignored even when it could not be implemented. This memorandum should not be released to the public, since that would reduce its candor.

This process of reviewing the Administration's legislative proposals with an eye toward simplification should also be applied to all serious legislative proposals originating outside the Administration. Indeed, Treasury could use its insistence that the Code not be made unnecessarily complex as a practical weapon in attempting to reshape legislative proposals originating on the Hill. While there is no organized constituency for simplicity, it would be difficult for any member of the tax-writing committee or the Hill staff to object publicly to Treasury complaints that a particular proposal is too complex, especially if Treasury's objections were accompanied by specific suggestions for simplification. The OTP should make it known that it will be reviewing all proposals for complexity and will make meaningful suggestions for reducing complexity in its proposals, as well as in those advanced by others.

Treasury Drafting of Proposals

The OTP should institute a policy of preparing actual drafts of legislative proposals it presents to the Hill. This can be a time-consuming process, but it is an extremely valuable technique. The resources of the Legislation and Regulations Division of the Chief Counsel's office could be called upon to assist in this effort. This process has been utilized on an ad hoc basis in the past when the Assistant Secretary considered it beneficial.

As a technique for reducing tax complexity, focusing early in the process on the changes in legislative language that would be necessitated by a particular proposal is extremely beneficial. This does not mean to suggest that the principal complexity problems in the Code are attributable to poor draftsmanship--the statutory language of the Code is not itself a primary culprit with respect to complexity. While there are drafting techniques that could be utilized to reduce complexity, the greatest benefit of early attempts to reduce a proposal to draft statutory language is that it requires a close analysis of the reach of the proposal itself.

In the initial "drafting sessions," before an individual is directed to prepare statutory language, a legislative proposal is dissected and its implementation carefully considered. At that time many aspects of a proposal may be shown to be unwise, impractical, or simply unworkable. A poor statutory draft is often a symptom of a poorly considered proposal.[6] Without an effort to reduce the proposal to legislative language, however, a detailed analysis of the practical ramifications of the proposal is really not accomplished.

The drafting session provides a structured environment for analyzing a proposal; it requires review of other sections of the Code that will be affected and thus must be cross-referenced or amended if the proposal is added to the Code. The process will identify obvious simplification possibilities that may require slight or even major alterations of the proposal itself, and if these are discovered at an early stage, they are much easier to address; if discovered after the proposal is finalized and made public, such changes are often not feasible.

Simplification techniques can alter proposals in ways that will reduce complexity and will, in addition, permit simpler legislative language. For example, adoption of a single set of attribution/related-party rules for use throughout the Code, as suggested earlier,

would obviously be a substantive change in the law, and would be a change that would permit significant reduction in statutory language, thus simplifying the Code. The simplifying technique in that case would be the uniform use of an established concept throughout the Code, and the drafting would follow suit.

Other simplifying changes could have meaningful impact while requiring little imaginative drafting. For example, if the number of taxpayers affected by the uniform capitalization rules, the time-value-of-money rules, or the passive loss rules could be reduced by dollar thresholds or by some other easily understood and applied technique, a significant reduction of complexity would be achieved. The drafting of this device would be important, but the substantive change in the law would be the significant ingredient. The point is that we should never lapse into the assumption that better drafting efforts alone can solve most of the complexity problems; nor should we assume, however, that the careful analysis and clear understanding of rules that is required in the process of converting a proposal to statutory language will not provide opportunities for meaningful benefit by reshaping legislative proposals to reduce their complexity.

Coordination With the IRS

The OTP director of simplification should have the unqualified support of the Commissioner of Internal Revenue and the Chief Counsel of the IRS. Ideally, a counterpart would be named in the IRS to ensure that the Service assists in the simplification director's efforts. The simplification director should have the ability to call on the resources of the IRS in considering the impact of legislative proposals on income tax forms and on the needs of computer programmers who serve tax return preparers. He will need a pipeline into the proper IRS offices for feedback on the many ramifications of tax legislation in the practical world of return preparation, filing, and IRS auditing.

Regulations Process

The simplification director should have the same authority and responsibility for the regulations process that he has in the legislative process. His activity in the regulations process should not be nearly as comprehensive, however. The simplification director would have to be selective in the regulations projects he chooses for input, lest his efforts be spread too thin. But once the simplification director decides that reduction of complexity could be achieved in a particular regulations project, his responsibility and authority for working toward simplification of those regulations should be the same as his responsibility and authority in dealing with legislative projects.

The director should coordinate most closely with his counterpart in the IRS with respect to regulations projects selected for his input and with respect to the process of attempting to make the regulation less complex.

Instituting any review of regulations in an attempt to reduce their complexity could, of course, further delay and complicate the regulations process. That will be a matter of particular concern in the OTP and IRS if the simplification director becomes too involved in regulations. Care would have to be taken to minimize this impact. This could best be

accomplished by limiting the number of regulations projects that are selected for simplification input.

While, undoubtedly, review of many regulation projects with an eye to reducing their complexity could yield substantial benefits, one should not set unrealistic goals. It is simply not feasible to institute a wholesale review of regulations for the purpose of reducing their complexity given the mammoth regulation task facing the Treasury and IRS now and for the foreseeable future. Thus, it will be much more productive for the focus to be on legislation, with the thought that the "ripple effect" of less complex legislation will eventually lead to less complex regulations. In addition, the effort on the legislative side should create an understanding of the need for reducing complexity in all the rules, including regulations. If a constituency for that viewpoint can be created, it will have a positive impact on the regulation process. Finally, the techniques devised for systematically simplifying legislative projects will have applicability in the context of regulations projects as well. Bright-line exclusions, horizonal drafting, even dollar thresholds where permitted by the statutory language, and other techniques can be employed to simplify the understanding and application of regulations if the drafters are sufficiently concerned about reducing complexity.

ENDNOTES

[1] C. Gustafson, ed., *Federal Income Tax Simplification* (1979), 28, reporting the proceedings of ALI-ABA Conference on Federal Income Tax Simplification held on January 4-7, 1978.

[2] It should be noted that the committee staffs have on occasion addressed concerns about unnecessary complexity in tax legislation. This was most recently reflected in the effort initiated by the Ways and Means Committee majority staff to simplify the corporate alternative minimum tax.

[3] The Joint Committee staff has also initiated programs to simplify the tax law. It initiated the highly successful, if long in coming, "deadwood" bill enacted as part of the Tax Reform Act of 1976, as well as comprehensive revision and simplification of subchapter S of the Code, enacted in 1982.

[4] Of course, the employee benefits rules of the recently enacted--then, more recently repealed--section 89 of the Code would have been at the head of that list had it not been repealed. The story of section 89 is the paradigm of provisions that attempt (and probably obtained) conceptual purity, but that are lost entirely under the weight of the complexity necessary to accomplish that objective.

[5] See Gustafson, *Federal Income Tax Simplification*, 31-34.

[6] Ward Hussey has said that the process of thoroughly analyzing a legislative proposal should consume 95 percent of the available time and that less than 5 percent of the effort should involve actual drafting. See above.

COMMENT ON "THE ROLE OF THE TREASURY DEPARTMENT IN REDUCING TAX COMPLEXITY"

FREDERIC W. HICKMAN*

I want to describe and comment on two general conditions that prevail at the Treasury Department that will limit and shape any effort at Treasury to do the kinds of things Buck Chapoton is suggesting, and then, having commented on those general conditions, I want to comment on four specific points in his paper.

The first of the general conditions is that the Treasury has a hyper-intelligent but hyper-inexperienced staff. And at the risk of putting you to sleep at the very outset, I want to read you a short excerpt from a paper that Bayliss Manning delivered to the ABA half a dozen years ago. He was asked in as a non-tax expert to comment on the then debt equity rules which Buck worked so hard on. His comments were not kindly. He said,

> The lawyer's urge to elaborate is not confined to the drafting of statutes and regulations. The same impulse drives us in our daily practice--drafting a contract, writing a prospectus, preparing a will--but every experienced private practitioner knows that as he does such work, he will eventually reach a point where he must make a calculated judgment to go no further in the elaboration. The veteran lawyer will deliberately decide not to draft against every contingency he can foresee. The veteran lawyer will make a similar judgment about the level of particularization at which he chooses to set the provisions of his documentation. He will consciously decide not to pursue the drafting to a finer grain of definition. The veteran lawyer makes these decisions consciously as a matter of self will and discipline, well aware that he will always leave some things open-ended and that there are risks inherent in doing so.
>
> The inexperienced lawyer does not do these things. He has not the perception, the judgment, or the self-confidence to tell him where to stop in the process toward particularization and elaboration. Not knowing where to stop, the inexperienced lawyer will try to define every term, then define every

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term in the definition. He will also seek to deal with every prospective contingency he identifies, not yet having learned from bitter experience that it will often turn out that he drafted against every contingency except the one that actually occurs.

So the veteran lawyer proceeds one way, and the inexperienced lawyer the other way, with what results? The work of the experienced lawyer will be brief, graspable, and ambiguous on certain points. The work of the inexperienced lawyer will be extended, difficult to comprehend, and ambiguous on certain other points. Elaboration in drafting does not result in reduced ambiguity.

A point which he then pursues.

It is an excellent paper. I commend it to you. It appears in Volume 36 of The Tax Lawyer.

But coming back to the Treasury specifically: the Treasury wants--needs--must have--the intelligence that it does presently have in the staff. It is, in effect, not permitted to pay for the experience. There is every incentive for the younger, inexperienced lawyers to do as Manning describes. That is how they demonstrate their ability and how they make their brownie points. Most of their efforts are directed at what Buck has described as level 3 complexities--the kinds that deal with bigger deals--while the big problems in complexity and complication are really in levels 1 and 2. That is only natural. Level 3 complexity is where the bright minds naturally go--to the complex problems. Who, after all, is going to hire them when they leave Treasury? Who wants an expert in simplicity?

When I left my office yesterday for the airport, one of my younger partners said to me, "Be sure you leave enough complication for us to live on."

There is no way for Treasury, or for us, to avoid all this. It is an unavoidable condition. I am reminded that the Israeli prime minister when asked about Syria said, "No problem."

The questioner asked, "What do you mean, 'No problem'?" He said, "A 'problem' is something that you solve. Syria is a 'condition'. A 'condition' is something you have to live with, and you do the best you can." And that is what we are faced with--a condition.

Only the assistant secretary and the senior, experienced members of the Treasury can deal with this condition. They must ride herd. They can teach; they can make sure that there are incentives to deal with these things more maturely; they can set the kinds of priorities that really need to be set. Mind you, these remarks are not intended as a criticism or a complaint about either the individuals on the staff or the Treasury as an institution. They are both extraordinarily impressive, as individuals and institutions go. I am only reporting on a condition that springs from human nature and is unavoidable and that must be taken into account. So that's the first condition that prevails at Treasury.

The second condition that is prevalent is one that seems to have infected even the senior officials. It is what I would describe as a theological--I am tempted to say pathological, but I'll leave it at theological--commitment to the Haig-Simons definition of income. There is abroad in the Treasury Department, as well as elsewhere, the view that tax policy is synonymous with conforming to the Haig-Simons definition of income.

I think it would be a great help, perhaps, if everyone from the tax policy office, from the assistant secretary on down, were required to pull Henry Simons' book off the shelf and read it. I suspect if we took a poll in this room we wouldn't find many who had seen it, let alone read it, even though they propose to treat it as "gospel." I am told it is even out of print. If you did read it, you would find that Professor Simons himself makes it very clear that his definition of income is framed in terms of how an income tax ought to be shaped. It was not proposing definition to be enacted, but a direction toward which one should try to move and a standard against which one should test things. Simons said:

> . . . One may remark at the outset that no government has ever undertaken to graduate taxes really on the basis of personal income . . . If three be any excuse for a treatise like this, it must lie in the importance of maintaining some broad--and perhaps quite "impractical"...conception in terms of which existing and proposed practices in income taxation may be examined, tested, and criticized." (Henry Simons, <u>Personal Income Taxation</u> [Chicago: U. of Chicago Press, 1938], 103-106).

Good tax policy, is <u>not</u> conformity to Haig-Simons. It is something else. It requires frequent departures from ideal theory. And even if it did not, you can't go to the Haig-Simons definition and answer a lot of the purely theoretical questions. Nowhere is there discussion of liabilities, for example, which is one of the things that plague us and that has created a great deal of the recent complication.

This theological commitment to Haig-Simons seems in large part to be a generational problem--that is, my generation isn't quite so affected by it. The current generation grew up hearing it. It is a sort of an intellectual spin-off, I think, from Stanley Surrey's tax expenditure campaign, which relied heavily on Haig-Simons. But Surrey himself wasn't looking for a Haig-Simons world; he was looking for his vision of a fair and administrable world. And I know from dealing with him over the years that Haig-Simons was often jettisoned by him when it interfered with those more practical goals.

Well, how do these two conditions relate to Buck's paper? His proposals need to be tempered with these basic conditions in mind. Specifically, I would make four comments.

The first deals with his proposal for a "simplification czar." I think that would be a move in the right direction, but the only chance of making it work, it seems to me, is to make the assistant secretary himself the czar. No lesser person can be a czar. A lesser person might be an ombudsman, maybe, but most ombudsmen end up regarded by the regular staff as being something between a dilettante and a public nuisance. And who can you get to do it at today's salary schedules, without the lure of public prestige; who is likely

to have the kind of experience that I talked about as well as the intelligence to do the job, even if he were to be promised the authority and the resources? (And who would believe such a promise?)

So I would suggest that the basic idea is a good one, but I think the way that it was framed in the Treasury Department would be very important, and the assistant secretary ought to think in terms not of a czar, but of a special assistant, to help him be the czar.

Second, the paper nominated the Office of Tax Policy to be the designated hitter. The reasons given for that are probably sound. That is the only office that it is practical to hold publicly accountable to the general public for trying to simplify. It can and should get out in front, and it should have to live in the spotlight. But it isn't necessarily the most influential office, and it shouldn't necessarily be thought of as the leader. It would, rather, be a kind of public conscience. The Joint Committee on Taxation is, in fact, much more responsible for legislation (although it can't really function as a representative to the public at large without compromising its role as a staff for the tax writing committees). It is fine and no doubt useful for the Office of Tax Policy to publicly carry the simplification monkey on its back, but there will, in fact, be no real simplification unless the Joint Committee is an enthusiastic partner in the real work.

Third, the suggestion for focusing on drafting techniques to reduce complexity is a useful proposal It is not a new idea, but it is an idea that is not an easy as it sounds and that is perennially lost in the shuffle. In any event, making it work would require that input of any experienced persons. It is not practical near term to redraft the Internal Revenue Code using the suggested horizontal drafting techniques. We can focus on it and apply it incrementally, but it would be tilting at windmills to think in terms of doing anything in wholesale fashion at an early date.

Fourth, and finally, the one point in the paper with which I seriously disagree is the de-emphasis the paper puts on regulations. Regulations cannot change the statutory provisions, but they can (and too often don't) make the statutory provisions enormously easier to live with. Regulations are the one place that the Office of Tax Policy and the Internal Revenue Service can strike a real blow for simplification--all by themselves, and without endless political compromises--and make it stick. In this connection, I applaud Commissioner Goldberg's emphasis on drafting regulations that emphasize basic principles and less detail. If the regulations clearly state the broad principles and approaches, and don't try to answer all of the details that may come up, my own experience tells me that we will have better guideposts and less complication.

COMMENT ON "THE ROLE OF THE TREASURY DEPARTMENT IN REDUCING TAX COMPLEXITY"

DONALD C. LUBICK*

I think Buck Chapoton has appropriately differentiated the complexity problems according to the kinds of taxpayers affected, and I concur that as far as level 1 and level 2 taxpayers are concerned, the situation today is really better than I can recall it in over forty years of practice. The '86 [Tax Reform] Act provided simplification in taking low-income taxpayers off the rolls and in reducing difficulties for ordinary taxpayers. It doesn't mean that there aren't problems for low-income taxpayers involving dependency, eligibility, status, head-of-household, things like that, fringe benefits and the like, but I don't think they are any more serious than those problems we have been coping with for many, many years, and in many ways they are better. There is a lot less record-keeping; we don't have to worry about sales taxes, a high threshold for medical expenses, lack of deductibility of personal interest. There is even a threshold for employee expenses, which I may not agree with, it may not be the right threshold, but it certainly reduces the level of compliance complexity.

The level 3 taxpayers that Buck refers to do constitute the bulk of our everyday concern as practitioners, and that is really where the IRS has monumental problems in dealing with their returns. Still, we don't want to lose track of the fact that there has been some easing in this area. When we worry about the complexity of the passive loss rules, we have to give credit for those mindless hours that we had to spend in advising tax shelter promoters.

Now, without diminishing the seriousness of the problem, we must take into account the fact that the number of taxpayers affected by serious complexity is probably a good deal fewer than historically, even though for the remainder it may be a more serious problem.

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Mr. Lubick has been a lecturer in Law at the University of Buffalo Law School and a teaching fellow in law at Harvard University. His professional activities include serving as chairman of the City of Buffalo Tax Revision Committee, as a former member of the Executive Committee of the Tax Section for the New York State Bar Association, as former chairman of the Committee on Domestic Relations Tax Problems for the American Bar Association Section of Taxation, and as a member of the American Law Institute. Mr. Lubick received his B.A. from the University of Buffalo (1945) and his J.D. from Harvard University (1949).

I'd like to deal primarily with Buck's suggestion. He would assign a pivotal role in addressing the problem for the remaining group to the Office of Tax Policy (OTP) and would focus, in my judgment, undue responsibility on OTP. I don't think it is either fair or wise to take any of the heat off Joint Tax or off Ways and Means or Senate Finance staffs by saying that they have to answer to legislators who can't be expected to care. I think, in a sense, that is a Nuremberg defense.

Section 89, PFIC, the pension rules--these things were not the creations, the recipes of the members. They were concocted by staff; they were sold to the members as carrying out some general policy of nondiscrimination or fairness or anti-abuse in the most general terms. But essentially the responsibility is on the staff in so many of these areas of complexity.

The same from the point of view of OTP. Even though members may have limited concern as to complexity and may make proposals that are inherently complex, I think OTP answers to an administration that may be disposed to do the same thing. I wonder if OTP were left completely to its own devices if it would be carrying the ball for the current capital gains proposals, research and development incentives, or the savings initiatives that are likely to be on their agenda this coming session. I do have a hunch that maybe OTP might be making some different proposals and that it is also answerable to a higher authority, not concerned with simplification.

Beyond that, I think OTP can bear a measure of culpability for the lunatic debacle of section 89, the horrors of our pension rules, many of the foreign area intricacies. OTP has always been assiduous in pressing for the adoption of intricate devices to keep waterproof the legislative dikes, just as the IRS has in its regulation proposals, and it is the analog, as has been referred to, of the professionals trying to build sieves out of the same dikes.

Simplification, as has been pointed out, always seems so admirable in the abstract, but with neither side willing to cede ground in practice, complex compromises always have and likely always will emerge.

So I have very grave doubts that a simplification czar, through jawboning, is going to be able to move many persons on either side of a substantive proposal. And I doubt that either the administration or congressional Santa Clauses are going to reach into their bags to take out presents to pass out to the kiddies if the simplification ones are charged against the budget that is allotted for those items that are on the big shopping lists that have been presented.

Now, I don't mean to give up on the notion, and I concur 100 percent with Fred that the motivation and the personal responsibility have to come from the Assistant Secretary himself or herself. It must be simply a high concern in the design efforts, and the assistant secretary has to insist and make sure that everyone on the staff has it as well. But the Joint Committee and the Senate Finance and Ways and Means chiefs of staff also have the same high responsibility in areas where they shape proposals. And as Fred has indicated, on each of the staffs are people who have practiced and can appreciate the

consequences of their actions. Too many of them have not paid concern to that, and the chiefs of staff have to see to it that they are sensitized to it and at least have the good sense to listen to those who have the experience, and they have to inculcate these attitudes.

Now, if there is going to be an effort to devise particular areas along the lines that Buck has talked about, I would say the way to do it is to take some of the contract money that is available to OTP to engage some of these alumni of the Treasury and staffs who have had practical experience both in the government, perhaps those who are now in academia, and let them be mini-ALI reporters. They can gather together professionals, IRS representatives, Treasury representatives, and do many projects for simplification. In that way, the precious staff resources of the OTP can be preserved and conserved for their current activities.

I think there is a major role for Treasury to play. I don't think that Treasury can be the designated point man as far as simplification is concerned. I think each of the staffs has to, under the direction of its particular head, have that as a concern of the head and the principal deputies, and that has to be communicated to the staff. I don't think we can simply pin the tail on the simplification czar's you-know-what.

Thank you.

TAX ADMINISTRATION CONSIDERATIONS IN THE DEVELOPMENT OF TAX POLICY

ROSCOE L. EGGER, JR.*

A former Assistant Secretary of the Treasury for Tax Policy once said that no tax increase is sufficiently simple or administrable but no tax decrease is too complex. I suspect that today not many people would really agree with Don Lubick's observation that certain features of recent tax legislation, although involving tax reduction, are not too complicated. When the TRA '86 was in its infancy, it was dubbed "tax reform for fairness, simplicity, and economic growth." As we look back, most of us would conclude, at least from the viewpoint of the corporate or business community, that the effort to achieve the simplicity objective fell far short. A few reminders will make my point. We were introduced to a laundry list of new terms, each of which required considerable definition and explanation. We were treated to such terms as uniform capitalization rule, passive loss rules, and the alternative minimum tax. Along with the alternative minimum tax came a new concept, business untaxed reported profits, or fondly, BURP. That has since been replaced with a thing called ACE, which stands for adjusted current earnings. Many practitioners and taxpayers still are not sure what these terms mean or how they are applied. In the installment sale area a new "proportionate disallowance rule was promulgated, and in the long-term contract area a complicated look back rule was developed to keep taxpayers honest.

In the foreign area, the complexity really shows up in such requirements as the new interest allocation rules or what is essentially a schedular tax concept in the new income "basket" approach for foreign tax credit limitation purposes. The new rules, requiring a virtual tracing of funds through corporate systems, seem almost like a game of "Can you top this?"

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Before becoming Commissioner of Internal Revenue, Mr. Egger was with Price Waterhouse from 1956 to 1973 and was engaged directly in the firm's tax practice as a specialist. He assumed responsibility for the firm's tax practice in Washington, D.C. from the beginning and continued in that role until 1973, when he organized and assumed responsibility for the firm's Office of Government Services. In addition, in 1971, Mr. Egger served as one of several private sector members appointed to the Commissioner on Administrative Review of the U.S. House of Representatives.

Surely one must ask, "Was this trip necessary?" Traditionally, the parent about to punish his or her child says, "This hurts me more than it does you." There is more truth than poetry in that statement in the case of the Internal Revenue Service, since the IRS is in fact hurt as much or more than taxpayers by complexity in the tax laws. Let's not lose sight of the fact that the job of the Service is to administer the entire system, and complexities in the law make that a nearly impossible task. The necessity to write regulations and to issue published ruling positions is merely step one in the job of trying to provide guidelines for taxpayers to assist them in meeting their compliance responsibilities. The job becomes really difficult when it is necessary to answer taxpayers' specific questions concerning the application of a new law or ultimately to pass judgment on taxpayer returns in the examination process.

Given the nearly impossible task of recruiting, training, and retaining adequately competent staff in the face of severe budget and salary limitations, new and increasingly complicated tax laws fly right in the face of the main strength of our system: voluntary compliance.

The standard question is, Why don't they do something about it? The real questions are, Who is they? and Where does the problem really lie? Is it in an overcomplicated statute?

Does the Congress discharge its responsibility in the development of tax legislation? Are the regulations too complicated? Does the Service misconceive the intent of Congress in enforcing the law? Is the IRS too aggressive? Is the present system, including the structure within the IRS and Treasury Department, adequate to protect the taxpaying public against the ravages of complexity? Probably every one of these is a contributing factor in the difficulties of taxpayers and tax administration.

Let's talk first about the Congress. Prior to about 1962, tax legislation was enacted typically by the introduction of specific legislative language in the form of a bill that was then referred to the Ways and Means Committee of the House, and after a respectable period of time for taxpayers to familiarize themselves with the bill, hearings would be held to give the taxpaying public an opportunity for comment. Since that time, the pattern has changed from hearings on a specific bill to hearings on concepts without the benefit of legislative language and, even more recently to the development of concepts within the committees or in caucus groups, which after having been twisted and tortured beyond recognition, are frequently passed in committee in the wee hours of the morning, followed by a hurried drafting job by overtired, overworked staff with virtually no opportunity to review the proposals in their final form from an administrability point of view. To paraphrase an old saying: People should never be required to see how either their tax laws or their sausage is made.

Is the Congress alone responsible for this state of things? The answer is pretty clearly no, since both the Treasury and the Internal Revenue Service have participated in the development of legislative initiatives, including such things as the penalty interest and other portions of the Code leading to ludicrous results for both taxpayer and government when it comes to application and enforcement of the law. Many of these provisions are

neither simple nor understandable. As Pogo said about nuclear physics, "It doesn't seem new and it surely isn't clear." Consider, for example, the requirement for tax shelter registration. This provision, both sponsored by and encouraged by the IRS, turned out to be an administrative nightmare that ultimately did not serve any particular purpose except possibly as a deterrent. I hasten to say, however, that it seemed like a good idea at the time. A recent proposal that has been encouraged by the Service and Treasury in the international area would require the maintenance of voluminous and detailed records in the United States by affiliates of foreign institutions.

As this proposal went through its varying stages of the legislative development process, one was reminded of the title to a mystery movie, I Wake Up Screaming. Often the tax administrator, frustrated with taxpayers taking positions that are "aggressive" or worse, discerns the need for information or aids to enforcement without really seeing the burden thrust upon the taxpayer by the requirements.

Some of you will recall the requirement for the filing of returns by small one- or two-person deferred compensation plans such as Keogh plans, etc. The response of the tax administrator was to require the filing of then-Form 5500. It's fair to say that probably no one in the Service at that time--and that includes me--really thought through the headaches the use of that particular form for small plans would create. The controversy that followed, of course, gave rise to the rapid development of a simplified Form 5500. Another illustration of the kind of problem had to do with the famous auto log regulations. Here, although this was a congressional initiative, the Service undoubtedly was in favor of some such rules because of the extreme difficulty of enforcing the rules on any reasonably uniform basis.

It's hard to say whether the regulations should have been as extreme as they were, but in defense of tax administration, the regulations followed the committee report pretty closely. In the sometimes-heated comments that followed in hearings on these particular regulations, one member was heard to say that he hadn't read the report but expected the tax administrators to exercise good judgment.

Probably the outstanding example of the century was the yo-yo actions of the Congress in deciding to require withholding on interest and dividends and then replacing the withholding requirement immediately with the present rules, called "back-up withholding." In terms of complexity for everyone, this takes the prize. Watching the process was a little like watching an old Keystone Cops movie.

And then of course there was the famous W-4 controversy, where taxpayers were faced with the necessity of filing a form that they found virtually impossible to understand and to prepare. Forget that the form was designed by people who had a fairly thorough understanding of the legal requirement; forget that the W-4 did, in fact, do the job that Congress had mandated. The fact remains that the burden thrust on the taxpayer was overwhelming.

Clearly, some of these problems could have been headed off or at least attenuated had there been a mechanism within the Congress and the Administration for a thorough review of the administrative impact. I'm reminded of the clamor for environmental impact studies before certain actions take place, as well as the requirement for regulatory impact review before regulations are issued. Although in theory Internal Revenue Service regulations are subject to this same rule, the plain facts are that because most of the regulations issued by the Service are interpretive regulations as distinguished from so-called legislative regulations, they are not really subject to any significant administrative impact review. Moreover, these regulations are reviewed by staff in the Office of Management and Budget who are rarely qualified to look at these regulations from the standpoint of the true administrative burden placed on either the Internal Revenue Service or the taxpayers.

And also, one has to reckon with the fact that in any large bureaucracy (government or private sector), people and groups concentrate so intently on solving their own problems that they are frequently impervious to the problems of others--and sometimes they don't even care.

On the congressional side, the Congressional Budget Office is supposed to opine on certain impacts of tax legislation such as the impact on the budget, the impact on inflation, etc., and almost uniformly, the letters that accompany each tax act are perfunctory at best and shed almost no light on any of the real problems.

One of the suggestions that is frequently made is to have more direct involvement by the Internal Revenue Service in the development of tax legislation itself. While recognizing that members of the Office of Chief Counsel typically participate in the drafting sessions on Capitol Hill, the individuals involved in this activity are almost never really knowledgeable with or experienced in the enforcement functions of the Service (such as examination collection or criminal investigation), and even less with respect to the processing function. Accordingly, they have little, if any, real ability to recognize or do much about the administrative burden falls on the Service and probably little experience to recognize an undue administrative burden on the taxpayer.

In the case of the TRA '86, the Internal Revenue Service was more than usually involved in the process. In 1984, at the request of the then-secretary of the Treasury, Donald Regan, the Internal Revenue Service assembled a sizable team, who worked right along with the staff of the Assistant Secretary for Tax Policy in the development of the first proposal, which went to the White House and was immediately dubbed Treasury I. This was a working document that provided the basis for the President's proposal for tax reform, which was submitted to the Congress the next year. Throughout both of these efforts, the Internal Revenue Service played a significant role. This was followed up by direct participation on Capitol Hill by senior IRS staff working with the staffs of the Treasury and the tax-writing committees of the Congress. Notwithstanding this involvement, as we know, the final version of the TRA '86 contained many, many highly complicated provisions. Certainly, some of these could have been recast or even eliminated in the interest of administrative ease.

Frequently, ideas for compliance or other initiatives in the area of tax administration are developed by the enforcement functions or other groups within the Service and are passed on to the Treasury, and sometimes even to Capitol Hill, by such groups without going through the normal legislative review staff process.

Given the extent of the problem and the involvement of so many groups and branches of government, we need to recognize that as desirable as simplification sounds, there are built into our system definite enemies of simplification; for example, in the recent past almost all tax legislation has been revenue-driven. As a result we've seen the Congress time after time enact provisions that have the effect of increasing revenues but have little or no tax policy justification. Specifically, in the rate structure we have the so-called 33 percent bubble, in which many middle income taxpayers are pushed into a third 33 percent bracket at the margin. One is put to the test to discern any really justifiable tax policy rationale for this result. Clearly, the uniform capitalization rules are another example of the same thing. These rules have a onetime impact for the purpose of raising revenue, but again have little to recommend them in terms of logic or tax policy justification.

Second, almost all tax legislation has been enacted on a kind of crises or last-minute basis, recognizing that in part this may have become necessary in view of extensive lobbying efforts, which tend to "water down" changes in the law but which nevertheless result in ill-conceived provisions. Finally, we must recognize that taxpayers and practitioners have become much more aggressive in the compliance area. This has been thought to have made necessary the provision of more specific rules in the statute as well as penalties, which in the day-to-day world often create ridiculous results.

I think we need to understand that in the vast majority of cases, the consequences of complexity might be more acceptable to the taxpaying public if there was some mechanism in our system of tax administration for the quick resolution of difficulties when they arise, a better system for the development of guidance, and a more efficient method of correcting inadvertent errors of inadvertence on the part of both government and taxpayers.

With those thoughts in mind, let's turn to what possible steps could be taken to alleviate the situation. It seems to me that these problems can be categorized as those that are peculiarly within the control of the Congress and those that are peculiarly within the control of the administrative process.

In the case of the matters on the side of the legislative branch of government, most observers would probably agree that as long as the budget pressures remain and the tax writing committees continue to try to respond to specified dollar objectives, I see little likelihood that the Congress can return to the old days of introduction of tax bills and hearings. The political implications, the opportunities for horse trading, and of course the necessity of making sometimes distasteful decisions are also factors at work to maintain the present approach.

Is there then room for more and effective input from tax administration in the legislative process? The answer to that is probably yes. The Assistant Commissioner's for

legislative liaison has ongoing contact with the staff and the members on Capitol Hill. Clearly, this role could be expanded and a regular process of review with knowledgeable people in the enforcement functions could become a part of the role. This individual could then have regular liaison with the Treasury Tax Legislative Counsel (TLC) and TLC staff. This would of course include sitting in on taxpayer group meetings, for example, in order to make the Commissioner's assistant as knowledgeable as possible. Although I believe the expansion of this role is a good idea and will provide some benefits, I seriously doubt that many dramatic results will follow. The Congress primarily will simply not resist the political advantages of the hang fire or the last minute tinkering with legislative proposals, and since so many of the problem areas in the Code arise because of last minute or eleventh-hour decisions, it is not likely that even an expanded liaison of this sort would make many significant changes.

But wait, maybe not all is lost. Is there a role here for the oversight functions of the tax writing committees? Could the oversight subcommittees through a regularized hearing process develop specific instances of needed changes in the statute when experience shows the result of existing law to be much too burdensome, either to the taxpaying public or to our system of tax administration? Wouldn't an open forum of this sort provide a mechanism through which problems could surface without rising to the crisis stage?

On the administrative side, having in mind such problems as the auto logs and W-4s, what can be done to ensure that regulations, published rulings, revenue procedures, and so on are reviewed objectively for administrative impact? Clearly, this effort should receive the same high-level consideration and attention as the substantive questions and issues that arise in the regulatory process. After all, the effectiveness of the system turns very heavily on voluntary compliance, and this in turn depends on both an understanding, and ease of administration, of the tax laws.

It seems to me that there needs to be a role of true advocacy for taxpayers within the system. Such a function would have to include some activity such as an administrative impact study of significant regulations or rules, as well as some sort of public liaison in order to receive information from the taxpaying public. I mean the advocacy in this sense to be in addition to the present advocacy role of the taxpayer ombudsman, who deals essentially with cases that have gone awry in some manner in the normal process.

A number of things suggest themselves: a true ombudsman role for the purpose of nipping problems in the bud as they are identified and before they get to the point of creating a public uproar. For example, could such an advocacy role have identified the problems that arose from the auto log regulations or from the W-4 form design in advance? I think so. If a comprehensive ombudsman role could be developed that merges the two needs and is adequately staffed, I believe much could be accomplished. I could see the Commissioner requiring a sign-off by the taxpayer ombudsman before any regulations or rulings go to publication.

Clearly, this should be a permanent position filled by an individual who is highly knowledgeable in the enforcement functions of the Service and is at a sufficiently high level to have some clout within the system. Who other than the ombudsman is in a better

position to hear the complaints and take the pulse of the system from the taxpayer's viewpoint? Why not the same system for an analysis of the problems of the Service in articulating guidance on the application of the law and the enforcement of it. Shouldn't each have a place to go and someone who will listen and respond?

With the possible exception of Canada, most of the other developed countries in the free world do not have anything like the degree of split between tax policy and tax administration that we have in the U.S. I might also say that typically, parliamentary forms of government provide an opportunity for the tax administrator to have much greater involvement in the process of developing tax legislation and presenting it to the legislative body. With that thought in mind, one suggestion, which is not a new suggestion, is that there be created in the Department of the Treasury a new position of Undersecretary of Treasury - Taxation, or some such title. This position would have as a part of its responsibility both tax administration and tax policy. In other words, the Commissioner of Internal Revenue and the Assistant Secretary of Treasury would both report to the undersecretary, and it would therefore be the responsibility of this particular function or position in the Treasury to coordinate both tax administration and tax policy.

Given this kind of a structural arrangement, it would then be feasible for the taxpayer, ombudsman, or advocacy role to be part of the staff of the undersecretary. This would provide a mechanism for informing the responsible officials at the highest level of the need for changes or reconsideration in either tax legislative proposals or in the regulatory sense.

Having stated the proposition, I hasten to say that in most of the other countries where these functions are combined in one ministry or cabinet post, the positions tend to be more frequently career positions rather than political appointees. That suggests a degree of objectivity that might not be present in the case of an appointee serving at the pleasure of an elected president and thus obligated to carry out the policies of the appointing administration.

Historically, the Internal Revenue Service has been positioned to be as nonpolitical as possible. While that has not held true in some instances throughout our history, nonetheless, it is the case; and the Commissioner, together with the staff of the IRS, has been reasonably free of significant influence by those whose incentives are basically politically oriented.

One negative in this suggestion is that the Commissioner of Internal Revenue is already a level III appointee, thus giving him the same rank as an undersecretary. Reporting to another person of the same rank would probably prove distasteful to many candidates for the job, and the downgrading of the Commissioner position would have a negative effect on the entire agency. Therefore, while I feel it is important to identify this as a possible structural change that could have, under the right circumstances, some beneficial effects in the administrative impact of our tax laws and tax administration, I believe that the disadvantages are considerably greater and therefore it is not my recommendation.

So let me return then to the suggestion for an expanded role for the ombudsman. The present position is usually filled by knowledgeable, experienced people, but clearly the job is viewed as a stepping stone to higher, more authoritative positions in the Service such as District Director or Assistant Regional Commissioner. Accordingly, the position is less of a permanent career position than it should be.

I believe the whole function should be greatly expanded to encompass not only the present program for resolution of problems but also a significantly broadened program along the lines described earlier. The position would be at least at an Assistant Commissioner level and staffed to provide for listening to problems of every kind from the taxpaying public and from the various factions within the Service. Broad powers to cut across the traditional lines of authority would be necessary.

I will not attempt to lay out in excruciating detail the activities and staffing of this function, but clearly it must serve the objective of providing a forum through which curable problems within the system can be identified; an effective liaison can be maintained with Treasury Tax Policy, with the Legislative Analysis of IRS, and the enforcement functions; and last but not least, a solid pipeline can be laid out to the tax-writing committee of Congress.

What a great day it would be to be able to take your frustrations to someone who will listen and take curative action!

COMMENTS ON "TAX ADMINISTRATION CONSIDERATIONS IN THE DEVELOPMENT OF TAX POLICY"

WILLIAM F. NELSON*

We are supposedly talking about the administrator's role in simplification or capacity to assume just blame for existing complexity.

Roscoe Egger mentioned several situations over the past fifteen years in which the Internal Revenue Service made the mistake of suggesting something that it later regretted--car log regs and things of that nature. In general, however, I hope and think that the Service has learned its lesson over the past four or five years.

I can't think of a situation, and maybe somebody in this room will, where the Service has actually advocated complicating legislative change in the past few years. Indeed, the Service is often put in the position of trying to tell Congress and others, you know, You may think you can score revenue from this additional information or from these additional records that you want to require, but the fact is we can't change our computer system fast enough to transcribe that information for three or four or five or six years. So please don't do it to us now."

The fact is that in the current environment, in my judgment, you can assume that two or three things are true. Whether they can be changed is different. One is that the Service is at the end of the whip when it comes to increase in complexity. The Service is clearly overburdened in trying to absorb and assimilate the '86 Tax Reform Act. The Service recognizes that it has no interest in greater complexity.

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Mr. Nelson has served as a lecturer at the University of Virginia Law School. He has also been a speaker at various tax institutes, including the New York University Tax Institute, the University of South California Tax Institute, the University of Chicago Tax Institute, the University of Texas Tax Institute, the University of Virginia Tax Institute, the Southern Federal Tax Institute, the New England Tax Institute, the Tax Executives Institute, ALI/ABA, and PLI. Mr. Nelson received his B.S. from Mississippi State University (1969) and his J.D. from the University of Virginia (1972). He also served as editor in chief of the Virginia Law Review.

The second fact of life is that of all constituencies that affect legislation, the Service is the most hamstrung and the least able to affect the outcome of complicating legislation. Congress clearly can determine what policies it chooses to advance. Simplicity has not been a major Congressional concern. Base broadening, revenue raising without increasing rates, fairness, all kinds of tax expenditures, tax incentives--those things are the policy considerations that concern Congress. Simplicity is not among the issues.

With respect to the Treasury, the Treasury obviously speaks for the administration on matters of policy--and by the way, if it is not clear, I believe that the primary motor driving increased complexity is legislation, not administration. But as the spokesman for the administration, Ken Gideon must stand up and say, "I think that differential capital gains rates are a good thing." That is a predominant administration policy. Yes, it will add complexity to the statute and to the system, but this policy concern outweighs any concern about simplicity.

One of the difficulties in dealing with simplicity is that simplicity is really at the other end of that seesaw from all of the other policy considerations. We can broaden the base, we can be fair, we can raise revenue, and we can do all those things simultaneously, but none of those things can we generally do and make life simpler.

So the Service's plaintive whining about complexity is simply not being heard. Moreover, the Service is constrained--for good reasons, mind you--from speaking its mind to Congress about the complexity of proposed legislation.

The Assistant Secretary for Tax Policy, the Secretary of Treasury and the President have to run the tax policy system for the administration. Suppose the Service runs up to Congress and tells somebody how complicated the capital gains proposal is. You may think that is good, you may think that is candid, you may think that is honest. The problem is that the members have a selective ear. If they oppose the Administration on other policy or political grounds, they will listen to complaints about complexity and use them against the Administration's proposals.

If, on the other hand, we say something that the Hill proposes is complex, and the Treasury opposes it, then the view on the Hill is that we are simply the lackeys for Treasury, and these protestations of complexity are simply being made to put up a smokescreen for other policy motivations of the administration.

So the Service has a very difficult time in actually having an impact, positively or negatively, on complexity in the legislative process. But, the Service can be helpful. The Service does know how to go out and test forms, for example. It has done this from time to time in the past when time permitted with respect to legislation. One example is the funding for catastrophic health care in which the Service made very clear from focus groups and otherwise that this was going to be a big-time problem, complicated and politically difficult. Nobody wanted to listen. The Service can only be effective as an advocate for simplification if somebody cares enough to listen, and in general other policy considerations and other political concerns and other political agendas cause the Service's comments about simplification to be, in general, ignored.

Now, I want to reiterate, I think that the Service can help, and, given time--and time to react is very important in the legislative process--I think the Service can get organized to provide the sort of basic ground-level research for the legislative process that the Service routinely conducts in development of forms.

In any event, the Service at the present time has little capacity to impact the legislative process. Unfortunately, it is the institution that tends to be blamed for complexity, and it is certainly the one that has to live with it.

As to guidance, the Service with the Treasury can make some modest difference, in my judgment. I do not, however, believe that "short" is a synonym of "simple." If questions need to be answered and they go unanswered, the questions have not gone away. Moreover, I submit that the net effect of letting questions go unanswered is greater complication, certainly greater expense, in developing the law.

Secondly, if a regulation is short, and the view is we'll answer these other questions ad hoc in revenue rulings, in five years what the practitioner has to do is drag out fourteen volumes of the Cumulative Bulletin along with our regs to look at the law. To my mind, that is not simplification. It is great for book salesmen, but to my mind it is not good for simplification.

I do think--and I take a fair amount of the blame for this in the past few years--that there are questions that got answered that didn't need to be answered, at least in the first cut. Most of those questions that were answered were asked by somebody, and most of them were answered for a reason. And the courage that it takes for the administrator to not answer a question is to know that the taxpayer will in fact snug himself, herself, or itself right up to the line you draw, and if you don't answer a question--at least if you intend to give a revenue-positive answer to the question if you ever get around to it--you are giving away money. And it is simply not easy or appropriate in my judgment, notwithstanding protestations to the contrary, for the people who are writing regulations to implement revenue-driven laws to ignore the revenue impact of what they are doing. Having said that, I do think that the Service is not compelled to anticipate the answer all questions in a regulation.

The next thing the Service can do to simplify is to write more clearly in the regulatory process. There is a cost to that, and the cost is time. Every person in this room, I will warrant, has done a deal. Every one of you has sat down and either written or reviewed the first draft of a contract. That contract was reasonably well organized and consistent when you got through writing it. But then you had to negotiate it, and you negotiated it with a lot of folks. And every time somebody had something else to stick in or a different thought, or a change was made, or you had a second thought, you made the change in place, or you figured out how to make the change without having to rewrite your whole contract. Regulations writing is no different. Regulations, like contracts, are negotiated.

I warrant to you that you have never gone back and rewritten one of your negotiated contracts to put everything in flowing prose. Perhaps the Service and the Treasury ought to do that. Perhaps, once all policy decisions are made and a full draft is agreed to,

perhaps it makes sense to back up, hand the project to somebody with a clean slate and all the notes, and let him do it over again from scratch and put everything in place in logical order. That takes time. And the cost of doing that is that you get the guidance later.

Now, I am anxiously awaiting Commissioner Goldberg's and Assistant Secretary Gideon's efforts at publishing rougher cut regulations. I will warrant, however, that if my clients are on the wrong side of a roughline, I will be up here telling the administration that fairness is the only way, to hell with complexity, and my guess is, unless you all bite your tongues, you will also be in that position.

I am therefore somewhat--well, I am clearly--pessimistic about the ability of the Service qua Service to have a major impact on simplification. I think that the Service can be helpful in the legislative process, and I think the Service working with the Treasury can make marginal improvement in the regulatory process.

COMMENT ON "TAX ADMINISTRATION CONSIDERATION IN THE DEVELOPMENT OF TAX POLICY"

JENNIE S. STATHIS*

I did want to say, and maybe I shouldn't, that in preparing for this conference and thinking a little bit about what is complex, what is simple, and what forces might affect complexity, my mind started going to all of the changes in Europe and the increasingly global economy that I see; and my final guess was that most business taxpayers are going to have a lot more complexity to deal with over the next decade than they have in the past. I'll quickly get off that sad prediction and go to Roscoe Egger's paper.

I think that all the parties in the tax system are continually making trade-offs among a variety of objectives--equity, accuracy, simplicity, just to name a few. Implicit in Roscoe's paper is the view, with which I agree, that one basic reason for complexity is the lack of credible evidence of the effects of proposals or even laws after they are passed. Often Congress is forced to act without a clear picture, and why is this so?

When special interests advocate a particular tax change, they often only know how it will affect their constituents; they don't really know how it might affect other taxpayers. I think that similarly, tax professionals view a change in the context of their own clients, their own knowledge base. And the IRS is such a large and decentralized agency that there is rarely any one person who can tell you the total effect of something that Congress is contemplating.

Aside from those reasons for lack of good, systemic kinds of information, there is always the worry that all of these different parties who are coming to visit someone on the Hill have some bias or some self-interest in what they are saying.

As Roscoe Egger pointed out in his paper, people and groups are interested in their own problems and are frequently unresponsive to the problems of others. An example here is the W-4 situation, which Roscoe mentioned. When a lot of taxpayers complained, the

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media carried stories, the oversight subcommittees held hearings, and a resolution was reached. But the cost to the IRS was great and included not only in the cost to develop that one form, but also in the opportunity cost (that is, the time and effort that could have been spent somewhere else.)

So I think that Roscoe's idea that one of the ways of avoiding complexity is to come up with a way to quickly develop and convey good information about effects is a good one.

I think that the IRS has a lot of this information already. It is just in a lot of different places. And one way that Roscoe's proposal could be implemented would be by bringing together a lot of information that already exists. The tax form committee puts together mock ups of forms; when those have been introduced in the legislative process, they have sometimes shown how complex something can be. Similarly, I don't believe that the focus groups the IRS began using after the W-4 incident are used on all forms but only on the ones that apply to more taxpayers. That particular process could be expanded, and that information factored in sooner in the process.

The IRS is using compliance teams in the service centers to look at tax returns when they come in and identify problems. Teams could be used to collect information. There are industry specialists in the coordinated exam program who have a lot of knowledge about particular industries. And there the IRS has town meetings, polls taxpayers, and does a variety of interviews; all that information could be funneled in and used in this particular process.

Note that all of these mechanisms I have mentioned deal with effects on taxpayers. I believe that one of the least understood and least known effects of proposals is their effect on the IRS. Who gives any thought to how many weeks of programming it is going to take to change the computer system to implement something; whether it even can be done, given the system that they have; or whether some simple change would make it a lot more easily implemented?

To get at those kinds of questions will require some new mechanisms. The IRS now uses task forces when a particular problem develops, and that same concept may have to be used when proposals are coming along.

I think that the office of this selected official that Roscoe mentions could also be used as an avenue--a hotline, if you will--to which IRS employees on the front line can suggest ideas. There are a lot of tax examiners, revenue agents, people out there who deal with taxpayers every day. They often know what the effect is going to be. They have some sense of what kinds of complaints they are going to hear, and we have found in our work that they often have some really good ideas. But they often don't have an easy way to convey that information to the right people or don't know where to send that information.

I also think that there is a role for professional groups, such as the ABA and AICPA, either individually or combined. The more widespread your information, the more systemic it is and the more valuable I think it will be in providing some early warnings of problems that might arise.

And what will we do with that systemic way of collecting all that information? How will it be used? I think that the IRS can use it administratively to try to simplify some of the programs it has responsibility for. But there may not be enough time in the legislative process to do that, as Roscoe mentions. I think that delayed effective dates when the situation will allow that is one way of providing more time for those things to be factored in. Another way is to provide in the legislation itself that we are going to think about the effects and collect the information that will be necessary to make that kind of judgment.

Another important consideration is how all the folks and the staff responsible for drafting laws and regulations are going to value and use that information. I was thinking about my own staff. I have a multidisciplinary staff of economists, some attorneys, some accountants--a variety of specialists and a whole bunch of generalists. Yet, I think that they all view things in somewhat stereotypical ways. You can always expect the economists to raise a particular kind of question and to view something in a particular way. I also think that by the time we have finished looking at an IRS program, we have enough knowledge of the IRS and its problems to know whether our recommendations are really going to work.

I worry that staff members don't have enough practical business experience to really know how business is going to react a tax law change, and I often send people out to try to get that information. But it occurred to me that some of the other organizations that are responsible for developing legislation and regulations may also need to think through either the professional backgrounds or experience levels of people that they have involved in the process.

I guess my one quibble with Roscoe's paper concerns his comment on revenue (and I think that my comments parallel those of Ken Gideon and of Dave Brockway), and that is as long as we have a budget deficit, we are going to have to be concerned about revenues, as unpalatable as that may sound.

So I would think that finding a solution to the structural deficit problem might be a good step in the direction in which we want to head.

COMPLEXITY IN THE TAX LEGISLATIVE PROCESS: PROBLEMS AND PROPOSALS; ROLE OF CONGRESSIONAL STAFF AND TAXPAYER REPRESENTATIVES

BERNARD M. "BOB" SHAPIRO*

INTRODUCTION

Complexity in the U.S. income tax system has been well documented. Authoritative pieces have been written on the causes, and many views expressed on what should be done. Although many of the proposed solutions are commendable and necessary to foster the need for simplification, two that are gaining academic interest--the holding of a simplification convention and encouraging taxwriters to draft simple statutory laws leaving technical details to Treasury interpretation and regulations--are unlikely to occur given present congressional attitudes as well as the pressure for more, not less, statutory certainty.

This paper is designed to focus on tax simplification from the view of "how to do it" in the present environment of the legislative process. It does not focus on specific provisions except where necessary to discuss tax policy within the context of the process.

Two elements are critical for tax simplification to occur. First, there must be a vocal constituency for simplification, rather than just general lip service to the goal of a simpler tax code. Second, there must be changes in the tax legislative process. These changes will not occur quickly.

I am making several proposals to foster tax simplification in the tax legislative process. One may be viewed as controversial and possibly radical in the present political climate, while the others are more within the traditional process. Nevertheless, changes must occur if Congress is to make a serious effort to achieve simplification.

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Questions do have to be raised: first, Is there a constituency for tax simplification? second, Where is the need? and third, Who wants simplification?

Since politics and economics have dramatically affected the process of and complexity in the tax system, it is important to review the congressional reforms in the 1970s and the major political influences on tax policy in the 1980s. Only by looking back can we understand how the present system developed. This will better enable us to look ahead to decide how the present system can be improved.

Tax policy and process have also been significantly affected by the roles of congressional staffs and taxpayer representatives (lobbyists). Each has had a major impact on our tax system in recent years. Consequently, their roles and influences must be understood if meaningful simplification is to be achieved.

This paper, in chronicling the tax policies over the last two decades that have produced much of the complexity of our present tax system, repeats many of the same facts to explain or illustrate different points. As a result, there will be repetition from one section to another. The full development of each section is dependent on this repetition, particularly for those readers who do not read all sections in the order in which they are presented. Accordingly, please bear with the author in this respect.

This background information lays a foundation. The author lived through this period, first as a member of a congressional tax staff, and closely involved with the process and then as an observer of the process from the outside looking in. The views expressed are therefore the author's alone.

PROBLEMS: POLICY AND PROCESS CAUSES OF COMPLEXITY

Is There a Public Constituency for Tax Simplification?

In a poll of members of Congress asking whether they support tax simplification, the answer clearly would be yes. If Congress supports tax simplification, then why don't we have it? The reason is more obvious than many of us may want to admit: there is really no public constituency for tax simplification.

If you asked the public whether they support tax simplification, the answer also would come back yes. But then, if you asked whether they would support the elimination of particular exclusions or deductions, coupled with rate reductions, in order to have simplification, I think the answer would be no. On the other hand, if you asked what areas should be simplified in the tax laws, the responses would probably be that the rules for employee expenses and miscellaneous itemized deductions, passive losses, or investment interest should be simplified (which means liberalized or repealed). Thus, when taxpayers say they support tax simplification, they really may mean this: "If simplification means that I pay less tax, I support it; but if simplification means that I would or may pay more in taxes, count me out."

The business community often shares this attitude as well. Few concerns for complexity were voiced about proposals for the investment credit, accelerated depreciation, domestic international sales corporation benefits, or research and development credits. It is true that these proposals had desirable objectives, but at the same time each added significantly to the complexity of administering the tax laws.

Each senator or congressman represents a constituency of individuals and businesses within his or her state or district. If there were a strong public constituency for tax simplification, Congress would make simplification a major goal during its consideration of revenue bills.

It is clearly within this context that we should analyze tax simplification as we look at the role of the Congress, its staffs, and lobbyists. It is all too easy for us to blame these groups for complexity; but members of Congress, as elected representatives, respond to the voice of their constituents, and these constituents have not favored simplification when it gets down to the specifics of accomplishing it.

Let's begin with a review of some basic tax policy concepts. This is necessary to assess how the problem of complexity might be dealt with from a legislative perspective.

Simplification: Where Is The Need? Who Wants It?

What Is Tax Policy?

The basic purpose of our federal tax system is to raise the necessary revenues for our government to carry on its national obligations and responsibilities. These revenues come mainly from individual and corporate income taxes; other sources include payroll taxes, selected excise taxes, estate and gift taxes, customs duties, and various user fees.

When legislators evaluate tax proposals from a tax policy perspective, three major criteria should be taken into account: equity, economic efficiency, and simplicity. This means that our tax system should raise revenue in a manner that is fair, causes little unintended distortion in the economy, and is easy to understand, comply with, and administer. Proposals should meet these criteria as far as possible to be considered consistent with good tax policy objectives.

Is A Simple Tax System Fair To Individual Taxpayers?

Certain federal taxes are models of simplicity for most individuals. The payroll tax on employees and the telephone excise tax are examples. They are simple because the individual taxpayers by and large have had no rules to learn, no decisions to make, no information to assemble and process, and no forms to complete. Those sources of complexity are dealt with by someone else.

Conceptually, a head tax would be the simplest of all taxes. More realistically, a broad-based, low-rate tax system on gross income would be a very simple tax system for

individuals. (There would still be considerable complexity in a gross income tax system, both in terms of adding back many individuals to the tax rolls--who are off the tax rolls today--and in defining income.) If all income were taxed with no deductions, it would take a flat rate for individuals of about 12 percent to produce the same amount of receipts as from our individual income tax. But would this be a fair or efficient system? Would it be fair to tax the poor at the same rate as the wealthy? Is a progressive rate structure that is based on the ability to pay a fairer system? Would it be fair to disregard the size of the family, casualty losses, large medical expenses, charitable contributions, and other indicia of the ability to pay? Are certain nontax objectives or incentives encouraged by deductions or credits appropriate? Should fringe benefits be treated as income? and how should they be valued? These and many other questions about the appropriateness and reasonableness of such a tax system are valid.

What this suggests is that it is not possible to have a tax system with both considerable simplicity and complete fairness. As we add equity by adapting the tax to the personal circumstances of the taxpayer, we sacrifice simplicity. We have trade-offs and degrees of simplification and equity. This is also why tax simplification means different things to different people. Those who pay additional taxes as a result of the simple system are likely to argue that it is unfair.

Is the Tax System Too Complicated for Individuals?

The fundamental norm of the individual income tax in the United States has always been that an individual's tax liability should reflect his or her ability to pay taxes. The practical meaning of this principle has changed from one reform bill to the next, but the principle itself has lasted and no doubt will be with us for a long time.

The upshot of the ability-to-pay norm is that taxpayers must participate in the computation of tax because it is they who have most of the information about their ability to pay, as defined legislatively: How large is the family? Has money been borrowed or loaned? Have earnings been depleted by uninsured casualty losses or medical bills? Have earnings been contributed for the benefit of others? What business costs have been incurred in producing gross income?

In short, complexity enters the individual income tax in varying degrees for all taxpayers because the income tax is meant to adapt to personal circumstances. Moreover, additional complexity is faced by individuals who make investments or have business interests. The tax rules for these activities were particularly complicated by the base-broadening aspects of the Tax Reform Act of 1986 (TRA '86).

Measuring Complexity for Individuals

Measuring how complex the system is and where the need for simplification may be usually relates to the cost of the system to taxpayers. For most individual taxpayers, this means the annual filing of their tax returns.

Individuals who have income essentially from wages and take the standard deduction are eligible to file the short form. The process for these people is relatively simple.

Individuals who have the same type of income but find it more advantageous to itemize deductions, mainly because of home interest and state taxes, must file the long form. For the majority of these people, the process is not complex, although they may use tax return preparers to avoid the work, to ensure that they "get every deduction," or as insurance that they comply appropriately.

The complexity increases as individuals have income from sources other than wages, such as investment income. This tends to be more common in the case of higher-income or wealthier individuals. These people also tend to have the type of expenses that are related to their investments, which also adds to complexity. Most of these taxpayers use tax return preparers, so for them the complexity lies in keeping and collecting the records for the tax return preparer.

Those individuals who are self-employed or operate small businesses also have more complicated situations, but most of these people need accounting assistance for their business; the data retention and collection for tax filing usually takes place as a result of the accounting service.

Although this analysis may be oversimplified, the issue raised here is whether there is a real need for simplification for the great majority of individuals. Could the income tax system ever be made so simple that individuals could do their own returns without professional assistance? Probably not. Much of the complexity in the income tax reflects the inherent complexity of many business and investment decisions. Filing tax returns is not the criteria for simplicity as long as the compliance costs (tax return preparer fees) are within an acceptable range.

The issue of complexity in the case of individuals instead revolves around the concerns of tax advisers or practitioners who advise individuals on their investment and estate planning. Although the perception of most individuals is that the tax system is very complicated, they have accepted the use of tax return preparers. Few of these individual taxpayers complain about complexity in the tax system, because they just are not exposed to it.

The annual tax return filing process is generally accepted and routine. As long as the compliance costs are reasonable, the only real taxpayer focus is on the amount of taxes due. Thus, a taxpayer constituency is more focused on tax liability than on tax complexity. There is just no large public constituency for tax simplification.

What About Corporations?

The highest degree of income tax complexity now falls on corporate taxpayers. Because of the TRA '86, all corporations must compute not one but two separate, fully elaborated federal income taxes every year: the regular tax and the alternative minimum tax. TRA

'86 also introduced new concepts for capitalizing expenses and taxing foreign income, and corporate taxpayers regard these as especially burdensome.

Some believe that the greater complexity of the corporate income tax reflects a view among tax policymakers that corporations have a vastly greater capacity than individuals to cope with complexity and absorb its costs. In a phrase, "Computers can do anything." However, it now appears that concern over complexity of the income tax is leading to the formation of study groups and task forces, both in and out of government, for the purpose of finding less complicated means of accomplishing the current objectives set for the corporate income tax.

Some believe that one of the political reasons why the corporate tax has become so complicated is that since corporations don't vote in elections, it is more expedient to look to that sector when there are revenue needs. Also, polls have consistently shown that the public favors a corporation income tax. Thus, corporate base broadening gets all the attention. As discussed in more detail later in this paper, the frequency of change and multiplicity of new tax proposals--even before the ink is dry on recently enacted legislation and before regulations are issued on the prior changes--have added enormous complexity to the corporate sector.

To a much greater extent than individuals, most of whose basic exposure to the tax system is to file annual tax returns, corporations take taxes into account in planning for the future as well as for current transactions. The constant change and complex new provisions have made sound and rational business planning a mine field of uncertainty for many corporations, both large and small.

Compliance costs have skyrocketed for almost all corporations. Most corporations do not have the staff to deal with all the new requirements for complianceand, therefore, must use outside tax advisers, which may add appreciably to their compliance costs. Even larger corporations with bigger in-house tax staffs are struggling today. The system has become just too complicated for most corporations.

What About Tax Practitioners?

In one sense, tax complexity brings benefits for the tax professional because of the continued and growing need for tax planning and compliance services. On the other hand, this group should shoulder the professional responsibility of developing a constituency for simplification. In the final analysis, cumbersome and complex tax rules, written without proper regard for their administration, will hamper sound business decision making and curtail new investment. Tax professionals will share the responsibility for these inefficiencies.

What Are the Tax Policy Causes of Complexity?

There are three basic tax policy causes of complexity:

1. Use of the tax system for purposes other than raising revenue

2. Tax reform/base broadeners

3. Compliance

Each of these factors leads to the next one. The more the tax system is used for economic, social, and other nonrevenue objectives, the greater the complexity. When the system has too many incentives so that many taxpayers are perceived as not paying their fair share of taxes or when revenues are needed for deficit reduction, tax reform or base broadening becomes necessary, which adds significantly to complexity. With so many new rules, additional compliance provisions are necessary to ensure that taxpayers comply with the new law. Complexity is added and compounded at every stage.

Use of the Tax System for Purposes Other Than Raising Revenue

Although the main purpose of our tax system is to raise revenue, it also has been used as a substitute for, or complement to, federal spending. What has been at issue is whether an economic, social, health, energy, or trade objective is better accomplished by creating tax incentives for decentralized, private action or by creating a centralized spending program for public action.

Incentives for special activities through exclusions, deductions, or credits add complexity to the system. The proliferation of these special provisions multiplies the complexity of the tax system as it expands the general application of the rules to more taxpayers and sets up interactions between the provisions.

As the statute grows, with different intentions and interpretations placed on the various provisions, it becomes more difficult to understand the meaning of the language. In addition, planning for transactions requires a greater level of sophistication than is necessary or appropriate for our tax raising and collection process.

These special provisions have proliferated to serve various nontax objectives. For example, the investment tax credit (ITC), accelerated depreciation rules, and the research tax credit were adopted to encourage particular types of business investments deemed beneficial to the economy. The substantial rewriting of the ACRS provision since 1981, the tortured history of the ITC over the period 1962-86, and the two major restructurings since 1981 of the research credit illustrate how tax incentive provisions carry complexity into the tax law. As a further illustration, to carry out one objective--increased employment of certain disadvantaged individuals--three differing credit provisions have been used.

Other special provisions have focused on incentives or tax relief for individuals. These have included savings incentives (the short-lived "all savers" certificate and the often-modified IRA provisions), the earned income credit for low-income workers with dependents, and the child care credit, which has been revised on a number of occasions.

Effect of Incentives on Complexity

Each special tax incentive has had a desirable purpose and a constituency. Although the tax policy objectives of equity, efficiency, and simplification should be taken into account in considering these proposals, it is not always possible to give each of these full weight in designing a proposal. In fact, efficiency and simplification will always suffer when a proposal is designed to promote a specific activity.

Even though some criticize the Congress for enacting these special incentives, which have led to complexity in the system, we should remember that many were initially proposed by the administration. Congress enacted them (often with substantial modifications) and had the encouragement of private industry, organized labor, or both, in most cases.

As more special incentives were enacted, the tax system became more complex. Individuals and businesses have responded by taking advantage of the provisions to obtain the favorable exclusions, deductions, or credits. This behavior affects the economic efficiency of the marketplace while at the same time complicating decision making, since taxpayers must take into account the tax as well as the economic and business effects of a decision.

Tax Expenditure Concept

Stanley Surrey, Assistant Secretary for Tax Policy during 1961-1968, first referred to the use of the tax system to achieve social or economic policy goals as "tax expenditures." Whereas the congressional appropriations process provides public spending for a specific purpose, the use of the tax system to energize private spending for a specified purpose through tax expenditures is considered to be "backdoor spending."

Moreover, as these incentive provisions have been reviewed over the years and adjusted to better fit their intended purposes, more complexity has been added. Thus, the cumulative effect of all the special provisions--along with the efforts to narrow their applicability--has been enormous additional complexity to the tax system.

Tax Reform/Base Broadeners

In the last twenty years, Congress has enacted three major tax reform bills: 1969, 1976, and 1986. The first two primarily represented reactions to taxpayers who used "too many" tax preferences and tax shelters and thus were not viewed as paying their fair share

of tax. TRA '86 bill was initially developed to achieve simplification and fairness through broadening the base and lowering the rates; however, it was a comprehensive tax reform effort driven by a desire for very low rates, which resulted in significant base broadening. The final legislation added much complexity, particularly for higher-income individuals and corporations, with the emphasis shifting from simplification to other goals.

Genesis of Tax Reform

When the Treasury Department recognized in the early 1960s that individuals and corporations with significant income were paying little or no tax through use of tax preferences, studies were undertaken to review most of these provisions. These Treasury studies were published at the end of the Johnson administration and served as the basis for Congress's consideration of tax reform in 1969.

The objective of tax reform in 1969 was to review tax preferences to see if there was still a valid purpose for their continuation. If not, the incentive preferences were to be repealed. If the desired purpose was still believed to be appropriate, the provisions were to be limited in general application and targeted to be more directly effective. As a backstop, a minimum tax was enacted to ensure that all taxpayers would pay some tax.

Base Broadeners to Raise Revenue

When there has been a need to generate revenue but rate increases could not be enacted because of political or policy considerations, the only source has been the base. Thus, the tax bills of 1982, 1984, 1987, 1988, and 1989 (as well as the TRA '86) cumulatively made an enormous number of changes in the base of the tax system, driven by the pressure to raise revenues.

Effect of Tax Reform and Base Broadeners on Complexity

Although tax reform, as well as revenue-driven base broadener bills, has been designed to increase equity and economic efficiency, a consequence has been an increase in complexity. To implement the new policies, new, tightly drawn statutory language is drafted covering many special situations and including limitations, caps, phaseouts, and transition rules. Thus, to achieve equity, much additional complexity is added to the tax system.

From 1969 onward, there has been a consistent focus on more equity and reform for our tax system. This has contributed to the explosion of new rules requiring a voluminous amount of legislation, regulations, and rulings to explain and interpret the new rules.

Compliance

The compliance area has received more attention for two reasons. First, as the tax laws have become more complicated, the Internal Revenue Service has raised compliance

concerns and Congress has enacted additional compliance provisions with stiffer penalties. Thus, reform-oriented legislation has led to a more elaborate compliance structure, which in turn has had the effect of adding more complexity to the overall system. There does not seem to be an easy way to avoid this merry-go-round.

The second source of complexity in the compliance area has been the recognition that by accelerating the payment of taxes, additional revenue is generated on a onetime basis to meet certain revenue or budgetary goals. Much fine tuning has been done in the compliance area to speed up the collection process. Stiffer compliance and accelerated collection requirements add to the complexity by forcing taxpayers and their representatives to respond faster to the overall process.

Overall Effect on Complexity

The use of our tax system for nontax objectives significantly adds to complexity. As more special uses of the tax system are made, the fine tuning of these provisions to make sure they work as intended and do not bestow "too great" a benefit on any individual or business, later cutbacks in the provisions to raise revenues, and the added compliance provisions to ensure that taxpayers follow the new law (or pay sooner to generate onetime revenue gains) all add to the complexity of our system.

Thus, it is obvious we are unable to have both a simple and equitable system. But can we make it less complicated?

Major Influences on Tax Policy in the 1980s

Three major influences on tax policy in the 1980s have had a significant impact on complexity: presidential politics, the enactment of indexing; and the federal budget deficit, which has required the congressional tax-writing committees to raise revenue for deficit reduction.

Presidential Politics

In all three presidential elections in the 1980s, tax policy has been a crucial issue. The subsequent emphasis by the White House on tax policies and congressional reactions have affected the tax legislative process and led to significant complexity in the tax system.

1980 Presidential Campaign

During the 1980 presidential campaign, Ronald Reagan campaigned on an economic philosophy referred to as "supply-side economics." One of its basic components was the Roth-Kemp three-year 30-percent reduction of individual tax rates and the "10-5-3" capital cost recovery system. After winning the 1980 election, President Reagan used this program as the centerpiece of his economic initiatives in 1981. Supply-side economics, including

across-the-board income tax rate cuts, were part of a larger strategy to reduce the size and role of the federal government by curtailing the ability to increase revenues for new or expanded federal discretionary spending.

The political landscape also changed significantly in 1981. The 1980 elections were a landslide victory for a new Republican President and swept into office a new Republican majority in the Senate, bringing in a new Republican Finance Committee chairman, Bob Dole, who would be an activist on tax policy and not willing to follow the traditional legislative procedures of waiting for the House to take the lead on taxes. The 1980 elections also saw the defeat of the chairman of the Ways and Means Committee at the polls. A new chairman, Dan Rostenkowski, became the House leader on tax policy. These political changes, coupled with a new economic and tax policy program, significantly affected tax policy in the early 1980s.

When President Reagan proposed his program in 1981, it set in motion a frenzy for tax cuts and special economic incentives. The President personally led the effort, which became very partisan. The Congress jumped in as both tax-writing committees began deliberations, essentially at the same time. The committee and floor battles were intense as Democrats and Republicans--as well as liberals, moderates, and conservatives--clashed both politically and ideologically, each competing for success and credit. The result was the Economic Recovery Tax Act of 1981 (ERTA), with revenue reductions of approximately $750 billion over a five-year period.

With such a large reduction in revenues and without commensurate spending cuts, the Federal Reserve Board, led by Chairman Volcker, forecasted huge budget deficits, which they believed would precipitate inflationary pressures. As a result, the Federal Reserve Board further tightened monetary policy and maintained this fiscal control while encouraging the administration and Congress to take strong deficit reduction measures. Two major deficit reduction bills followed: the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the Deficit Reduction Act of 1984 (DEFRA).

"Revenue enhancement" was the key driver in both of these bills; tax policy was not a major focus of attention. As a result, with the increasing number of changes being added to the tax system first from ERTA and then from TEFRA and DEFRA, the tax laws became more complex, and a growing concern for simplification began to develop. In 1983, Senator Bill Bradley, a member of the Finance Committee, and Congressman Richard Gephardt, then a member of the Ways and Means Committee, cosponsored a tax simplification and fairness bill, The Fair Tax Act of 1983, which sparked the interest in simplification. The fact sheet stated: "This legislation will make the federal income tax system simpler and fairer and the economy more efficient. It will reduce tax rates and eliminate most existing deductions, credits and exclusions. It also will raise revenues approximately equal to those collected under existing laws without changing the tax burden for any income group." Its basic premise was broadening the base and lowering the rates without increasing or decreasing revenues overall.

1984 Presidential Campaign

In the 1984 presidential campaign, Senator Bradley and Congressman Gephardt encouraged Walter Mondale, the Democratic candidate, to embrace their tax simplification program as part of his platform. But Mondale declined, stating that he wanted to make the deficit his campaign economic issue, since President Reagan had campaigned in 1980 that his economic program would balance the budget by 1984. With the deficits skyrocketing to $200 billion, Mondale announced that his economic program was to reduce the deficit and, as part of this effort, to raise revenues. Further, he specifically indicated the areas in which he intended to focus as revenue raisers.

President Reagan, on the other hand, avoided the deficit issue and, in response to Mondale's tax program, indicated that his tax program was not raising revenues but rather tax simplification. He indicated that he did not want to bring the specifics of his program into a presidential debate and he would present his program after the election.

During the course of the presidential campaign, the Treasury Department, under instructions from the White House, had been drafting a tax simplification program largely immune from political consideration. When this plan was reviewed in the White House after the election, it was viewed as so radical and controversial that it was released as a Treasury proposal in December 1984 rather than as the President's program. This proposal called for a sweeping overhaul of the tax system, eliminating many tax incentives while at the same time reducing rates. When it was ultimately proposed to the Congress by the administration in May 1985, it was modified in many respects and labeled *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, but it was often referred to as "Treasury II."

When the tax reform bill finally was enacted in 1986, it was so comprehensive that it touched almost every aspect of our tax system and significantly affected every individual and business. Its theme had shifted from tax simplification to an obsession for low rates, requiring much broadening of the tax base to achieve revenue neutrality.

This historic overhaul of the income tax system brought tax rates for both individuals and corporations to levels that no one had seriously expected. The trade-off was a substantial increase in complexity, particularly for higher-income individual investors, small businesses, and almost all corporations. For most low-income or middle-income individual taxpayers, the lower rates and limited effect from the base broadening actually simplified the tax system (except for the transition rules), while at the same time providing tax reduction. The number of taxpayers who itemize deductions was reduced from approximately 36 percent to 30 percent, and approximately 6 million low-income individuals were removed from the tax rolls. But for the others, the additional complexity was enormous.

1988 Presidential Campaign

During the 1988 presidential campaign, then-Vice President Bush uttered his "Read my lips--no new taxes" pledge that carried him not only through the campaign but also

into the beginning of his presidency. He also advocated reducing the capital gains tax rate to 15 percent.

This capital gains reduction became the centerpiece of President Bush's first budget proposal to the Congress and was the most controversial issue in this year's deficit reduction bill. This resulted in enormous political tension between the congressional Democratic leadership and the administration and congressional Republicans.

When the President submitted his budget, he proposed raising about $5 billion in revenues, mostly from his proposal for capital gains rate reduction. The Congress agreed with the revenue amount (which lessened the amount of spending cuts to be made) but not on the specifics, with the congressional Democrats again opting for base broadeners. The battle ensued; and when the smoke cleared, the capital gains proposal had been deferred to 1990 and another significant base broadening bill had been enacted, bringing with it another wave of complexity.

Indexing

Prior to 1981, the government received a revenue benefit--viewed by some as an unfair windfall--resulting from the fact that the tax system was not indexed for inflation. As inflation-based wage increases pushed individuals into higher marginal rate brackets (referred to as "bracket creep"), this hidden tax accounted for substantial additional revenues to the Treasury.

The administration and Congress actually received a double benefit because, in addition to receiving a revenue increase without new legislation, Congress was able to use this money periodically to provide apparent tax reductions. In addition, the Treasury and Congress were able to address inequities within the tax system with the use of this money. This all changed after indexing for individuals became effective in 1985, after the phase-in of the 1981 tax rate reductions was complete.

Although indexing in the tax system for individuals may very well be appropriate tax policy, the result was that the government lost this revenue at a time when deficits grew and political pressure to cut tax rates intensified. Congress found itself in a political bind: It required revenue increases from complex base broadeners but was unable to enact important corrective changes that might achieve greater simplicity or equity because of revenue constraints. Thus, a tax policy initiative, indexing, has made a significant contribution to complexity because of the huge revenue cost associated with it and other major provisions of ERTA.

On the other hand, it should be noted that many of the tax bills in the 1970s, which initiallywere designed to put the "inflation-generated tax" back into the economy, attracted many other initiatives that contributed to the complexity that occurred in the 1970s.

Federal Budget Deficit

Presidential politics has influenced tax policy in the 1980s in several significant respects. First, by campaigning for, and then proposing a major reduction in, revenues, President Reagan, with a vigorous assist from Congress, put the budget deeply in deficit. If this program had been coordinated by linking revenue reductions to spending cuts, the huge deficits might have been avoided. But the Reagan administration pursued a strategy of suffering a large budget deficit and reducing taxes to emphasize spending cuts and a diminution in the size and role of the federal government. The Federal Reserve Board's concern for the inflationary effect of this huge deficit caused it to use its monetary policies to check the potential inflationary spiral. The message was clear. Reduce the deficit by either spending cuts or revenue increases (on both), or tight monetary policy would remain.

Since President Reagan was firmly entrenched with a deficit policy of only spending cuts and no revenue increases, and the budgets for spending cuts he submitted to Congress were tagged ahead of time as "dead on arrival," this put tremendous pressure on the Congress. As a result, Congress had to deal with the looming deficits and Federal Reserve pressure essentially without the leadership from the administration or the support of the Treasury Department on revenue-raising bills.

Revenue-Raising Bills for Deficit Reduction (1982, 1984, 1987, 1988, 1989)

In 1982, with the pressure to deal with the deficits and a budget that was "dead on arrival," the Congress was put into a quandary at the outset. The chairman of the Ways and Means Committee, Dan Rostenkowski, made a political decision that he, on behalf of the Democrats, would not initiate a tax bill in the House until President Reagan agreed to lead or support the process. When President Reagan did not budge, Chairman Rostenkowski stood firm as well.

In the Senate, with a new Republican majority feeling the pressure to provide leadership, the chairman of the Finance Committee, Bob Dole, recognized that revenues clearly had to be a part of any program to deal with the deficit. He therefore initiated a tax bill in the Senate to raise revenues to deal with the deficit. For the first time, then, a major revenue bill was initiated in the Senate without a counterpart coming from the House. Thus the House's sole role in the 1982 revenue bill process occurred in the conference.

The result was a revenue-driven tax bill without any significant tax policy analysis from the Treasury or the House staff. This was a prescription for complexity. Before the ink was even dry on ERTA, many revisions were made as new revenue tighteners were added to the law, thereby bringing in the first wave of time-pressured, revenue-driven, complex tax bills.

During 1983 and 1984 Congress repeated this process. Even with the full participation of the House and some assistance from Treasury, DEFRA became a time-pressured, revenue-driven complex tax bill. The 1987, 1988, and 1989 bills also generally followed this pattern.

1985 Gramm-Rudman-Hollings Budget Act

The 1984 presidential campaign of President Reagan essentially ignored the deficit. The President kept pushing spending cuts as the principal means for deficit reduction, but Congress recognized that the time was now ripe for initiating a new budget discipline. This resulted in the Gramm-Rudman-Hollings legislation in 1985. It was meant to compel Congress to meet predetermined targets in order to balance the budget by 1991. (Congress subsequently delayed the balanced budget deadline until 1993.) It was anticipated by most Members of Congress that this would require both revenue increases and spending cuts, but it was left to the congressional budget process to determine how to meet the annual target deficit levels.

TRA '86

The budgetary theme of the TRA '86 was revenue neutrality, while the tax policy themes were low rates and a broad base. At the outset, simplification was a primary policy theme; however, during the process the political need for low rates resulted in the pressures to broaden the base substantially. This resulted in much lower rates than anyone ever anticipated, but at the same time, it brought with it many pressing decisions that were driven by revenue rather than by tax policy considerations in order to fund the rate cuts.

The President participated significantly in the legislative process. Each time tax reform faltered, he used his personal persuasion to push the program through Congress. With the President's support, both House and Senate roadblocks were pushed aside. Tax reform began to have a "life of its own." Many policy decisions were made that pushed tax reform ahead while sacrificing equity and simplicity to maintain revenue neutrality and lower rates.

STAFF AND LOBBYISTS: ROLES AND EFFECT ON COMPLEXITY

Effects of Process Changes on Tax-Writing Committees

In the 1970s a number of changes occurred in the tax-writing committees (particularly the Ways and Means Committee) that had a significant effect on the process, and thus the outcome, of tax legislation. Several of these changes, combined with a dramatic increase in tax legislative activity, led to the significant increase in the role and responsibility of congressional staff and the participation of taxpayer representatives. It also contributed to the increase of complexity in the tax system.

Ways and Means Democrats--Loss of Committee on Committees' Role

In 1974 there were a number of reforms in the committee process, particularly in the House of Representatives. Up to that time, one of the major roles of the Democrats on

the Ways and Means Committee, which contributed to its being considered the most powerful committee in the House, was that of the Committee on Committees. This meant that the fifteen Democrats on the House Ways and Means Committee made committee assignments for new Democratic members as well as for those members who wanted to transfer from one committee to another. The practical effect was to give the chairman of the Ways and Means Committee significant power in dealing with other committee chairmen and all House Democrats. To assure that the leadership would retain control of the process, the membership on the Ways and Means Democratic side was generally limited to members who had seniority and were not vulnerable in their re-election bids, which also tended to make them less vulnerable to pressures from outside interests.

In 1974, the House Democrats moved the function of the Committee on Committees from the Ways and Means Committee to a separate committee under the House Democratic leadership. This change profoundly affected the role and power of the Ways and Means Committee within the House leadership and ultimately in the legislative process.

Expansion of Tax-Writing Committees

House

Also in 1974, the House Democratic leadership expanded the Ways and Means Committee from twenty-five to thirty-seven (now thirty-six) members. By creating a super-majority of Democrats, with twenty-five Democrats to twelve Republicans (a ratio of two to one, plus one), the Democrats hoped to assure themselves of control of the panel. The Republicans bitterly attacked these ratios as not representative of the House makeup of Democrats and Republicans.

This change turned the mood of the committee from a generally congenial one between Democrats and Republicans to one of strong, often bitter, partisanship. Prior to this change, the Committee had made most of its decisions by consensus and the chairman tried to accommodate the concerns of all members without partisan differences.

With several departures from the committee at that time, this expansion added a significant number of new members to the committee and, for the first time, generally opened the committee seats to more junior members, many of whom did not have safe seats and as a result were more vulnerable to outside pressures with regard to tax legislation.

Senate

In the Senate, the Finance Committee increased from seventeen to twenty members (adding one new member in 1975 and two additional members in 1979), which means that one-fifth of the Senate has members on the Finance Committee. Since there has traditionally been more of a tendency to provide senatorial courtesy on issues of concern to particular senators, this meant that there were more opportunities now for pressures from outside interests to receive favorable consideration.

Subcommittees

Prior to 1974, neither the Ways and Means Committee nor the Finance Committee had subcommittees. This meant that all legislation was considered in the full committee.

House

When the House required committees to establish subcommittees, this meant a significant change for the Ways and Means Committee. The Ways and Means Committee created its subcommittees with legislative jurisdiction to report to the full committee. This meant that the subcommittees had to develop staffs to deal with that legislation, thus beginning a substantial increase in the number of staff on the full committee and on its subcommittees.

Although jurisdiction over tax matters was retained in the full committee, the Ways and Means Committee created a subcommittee to which the chairman from time to time refers "select revenue measures." This subcommittee has performed a number of different legislative functions, but in 1988 it embarked on the task of simplification when it considered the chairman's recommendation with respect to the corporate minimum tax.

Senate

On the Senate side, subcommittees were created by the Senate Finance Committee but were not invested with legislative jurisdiction. The full committee retained all legislative jurisdiction. As a result, the subcommittees essentially held hearings and were staffed by the full committee staff.

Because of the increased amount of legislation that had started to develop in the House and because more issues were being considered by the newly formed subcommittees, members began to designate and hire specific tax legislative assistants. Whereas in the past the members by and large reviewed tax measures themselves, now the increased legislative workload meant they were relying more heavily on their tax aides to keep them informed. It also should be noted that as the tax proposals became more complicated, broad policy considerations gave way to more technical issues and the members needed more assistance to deal with these technical matters. In the past, the technical and policy-related review function had largely been carried out by the staff of the Joint Committee on Taxation. The expanding workload and expanded committee staff contributed to less consistency and thus more complexity.

Hearings

A basic change in the tax legislative process has been the status and scope of hearings on tax provisions. From what had traditionally been extensive hearings in the Ways and Means Committee on proposed legislation (probably to an extreme in many cases), the Committee now has very limited hearings. In some instances, the proceedings appear to

be perfunctory (in order to say hearings have been held), rather than designed to obtain information or views from those who may be affected by the proposed legislation.

Hearings in the Senate Finance Committee in the past were essentially based on a House bill. The House would have passed tax legislation before the Senate began any consideration of it. This allowed affected taxpayers the opportunity to see House statutory language and the committee report. As a result, the Senate Finance Committee received informed and detailed views, criticisms, and recommendations (and stronger lobbying pressures) on the specifics of the House-passed bill, as well as views and recommendations on other proposals.

Today, many hearings in the Ways and Means and Finance committees are limited in scope and length and may be held on relatively short notice. Some witnesses conclude that they do not receive a fair opportunity to present their views, particularly if few members attend or seem to be paying attention. This leads to the conclusion that if affected taxpayers want to present their case effectively, they must meet directly with members and staff.

One important effect of the change in the hearings process is that it has shortened the timing for committee consideration and action. A lengthy hearings process for each bill afforded the staff more time to prepare background and relevant information for the members, who then could focus more thoroughly on the effects of certain proposals. A speed-up of the process increases pressure to act more quickly, with less information and less constructive input from interested taxpayers. This limited role for hearings has had an impact on complexity because less time is available for understanding the issues or developing simpler approaches.

Markup Sessions

Traditionally, markup sessions, the committee decision-making part of the process, were closed to the public. Only a few committee staff and Treasury officials were permitted in the room; member staffs were not allowed to attend. There were all kinds of perceptions as to what went on behind the closed doors. Although there were accommodations for member concerns, the members generally focused on tax policy issues, particularly in the absence of time or revenue pressures.

The 1974 House reforms opened the Ways and Means markup process to the public (including lobbyists) unless the Committee votes to close the session. Under the Senate rules, the Finance Committee generally cannot vote to hold a closed session. In recent years, however, many decisions by the Finance Committee on tax bill provisions have been made in closed committee "caucuses," followed by formal votes in open markup sessions.

Some observers of the legislative process argue that going from what traditionally had been closed markup sessions to open sessions has had an adverse effect on the process, rather than introducing "sunshine" into it. During open sessions, it is argued that members react to the presence of lobbyists and the press in the room. That is, because they want to make a favorable impression on the press and others, they may feel forced to take strong

stands on constituent issues or, more important, may be reticent to ask questions that could suggest a lack of knowledge and understanding of issues. In closed sessions, members may feel freer to take tax policy considerations into account or to ask for information on proposals being pushed by interest groups. Also, expansion of the committees and--particularly in the Ways and Means Committee--the addition of so many new members without seniority and safe seats affects the decision-making process.

Although many markup sessions in recent years have been formally or effectively closed to the public, the process has changed so much--particularly with time pressures--and the tax law has become so complex that it has been very difficult for the members to get more deeply involved in policy considerations. As the focus has changed to the amount of revenue to be derived rather than tax policy objectives, the rules on open markup sessions may no longer contribute significantly to greater complexity in the system.

Treasury Department's Role in the Legislative Process

The role of the Treasury Department and the administration in the tax legislative process also has changed significantly over the years.

Prior to the 1970s, when the administration proposed tax legislation, the Treasury Department would submit statutory drafts and, often, technical explanations with the proposals. This meant that much time and effort had been devoted by the Treasury Department to analyzing and refining the proposals prior to their submission. One advantage to having statutory draft language was that it compelled the proponents of a proposal to place the proposal in its legislative context and address related policy issues that had been flushed out in the drafting process. Thus, the policy and economic effects of the proposals had generally been more fully studied.

During the course of hearings, witnesses could comment on the full impact of the proposals, having been able to review proposed draft language and the technical explanations. Congressional staff also could prepare better, since so much prior analysis had been devoted to the proposals. This is one reason why there were no technical corrections bills until after the Treasury Department stopped preparing legislative drafts.

In the 1980s, another significant change occurred. Because the administration opposed revenue increases, the Treasury Department often played a lesser role in the revenue-raising legislative processes. Policy suffered and complexity increased with this resource and expertise on the sidelines during the consideration of many revenue bills. Again, this development alone did not cause complexity, but it was a contributing factor.

Role of Congressional Staffs

It should be noted at the outset that major policy decisions on tax legislation are made by the elected members of Congress. The staff do not vote, and their role is not to decide whether rates are to be cut or investment or other incentive credits are to be enacted,

modified, or repealed or an alternative minimum tax is to be enacted, etc. Rather, staff serve to provide technical assistance to the members. At the same time, because the nature of the legislative process has changed significantly, the role of the congressional staff has become more prominent. In addition, since the staff make technical recommendations and draft the statutory language and the committee reports, they do exert influence in the process.

Let's analyze the role of the staff and briefly set forth their traditional roles.

Traditional Roles

Prior to the mid-1970s there were relatively few congressional tax staffers (most of whom were on the Joint Committee staff); as a result, the members themselves devoted attention to specific tax proposals. Because today's time pressures did not exist at that time, the members had the opportunity to become more involved themselves in tax policy issues. Members were able to rely more on the analysis of the Treasury staff and the Joint Committee staff.

Tax-Writing Committee Staffs

The Ways and Means and Finance committees had small tax staffs; their role in the legislative process prior to the mid-1970s was somewhat limited. The Ways and Means Committee had two or three staff members who had tax backgrounds on the majority side and one or two on the minority side. These tax staffers generally did not actively participate in the legislative process other than to provide information to the members during hearings and assist them with questions they had during markup sessions. The staff also was responsible for responding to tax correspondence forwarded to the committee. In addition, the staffers attended the sessions in which the committee's decisions were formally drafted and reviewed the committee report, particularly those portions in which the members had a special interest.

On the Senate side, the Finance Committee did not have a minority staff until the mid-1970s. There were two or three majority staff who performed essentially the same roles as the Ways and Means tax staff.

Joint Committee on Taxation Staff

The major staff role during the tax legislative process was carried out by the staff of the Joint Committee on Taxation (JCT). This nonpartisan staff serves as the technical advisers to both tax-writing committees, as well as to individual members, and participates during the entire course of the tax legislative process, both in the House and the Senate, as well as the Conference Committee. The JCT staff prepares summaries of administration and other tax proposals, background materials to help members prepare for the hearings, and explanations and analyses, along with recommendations (or options), in documents used in markup sessions.

In markup sessions, the JCT staff has the principal responsibility of assisting the members in the decision-making process. At the same time, the Treasury staff traditionally was usually an active participant in advancing the administration's proposals and giving its views on alternatives or new proposals advanced by committee members. As previously noted, the Treasury staff's role was severely restricted during much of the 1980s.

When the committee finishes its conceptual decision making, the JCT staff participates in the formal drafting sessions conducted by the House or Senate Legislative Counsel's office, during which the committee's decisions are translated into legislative language. At the same time, the staff is drafting the committee's report to accompany the committee-approved bill, which is formally submitted to the House or the Senate for consideration and ultimate passage.

In conference, the JCT staff prepares a document outlining the differences between the two Houses' versions and participates actively in the conference process, during which the senior members of the two tax-writing committees have to work out their differences.

Member Staffs

Prior to the mid 1970s, Ways and Means Committee members generally did not have tax legislative assistants. As a result, the members participated in the hearings and markup sessions essentially doing much of their own preparation with the support of the committee and JCT staffs. As tax legislation began being considered more frequently, Finance Committee members acted sooner than Ways and Means members in designating personal staff to be responsible for tax issues. Since most senators serve on several major committees, they have less time for Finance Committee business. Unlike the Senate, Ways and Means members generally do not serve on other major committees and, therefore, delayed adding tax legislative assistants to their personal staffs for a couple of years.

Increase in Tax Staff

In the mid-1970's, the tax-writing committees and their members began increasing their staffs. The committee staffs became more directly involved in legislative matters. On the House side, the committee established subcommittees, and the subcommittees started developing their own staffs. As a result of these changes, the Ways and Means staff began to grow. Since 1974 the number of staff has more than tripled.

The subcommittees of the Senate Finance Committee do not have legislative jurisdiction and essentially only hold hearings. As a result, the subcommittees tend not to have staff; usually, the chairman of that subcommittee uses his own staff along with the committee staff to deal with the hearings and related matters. However, the full committee staff began to increase, and each member added at least one tax legislative assistant. In some cases, members use additional staffs in their office to support the tax legislative responsibilities because the increased amount of tax work over the years is more than the committee's staff and their tax legislative assistants can cover.

As the process began to change--with the decreased importance of hearings and the change to open markup sessions--the role of the congressional staff began to increase. On the House side, one major change that had a significant effect was the addition of many new Ways and Means members. More than one-third of the members were new when the committee was expanded in 1974. Between 1974 and 1978 alone, over two-thirds of the members of the committee were new. These new members generally did not have a previous knowledge of the tax system and thus had to rely more on the staff.

Because of the needs of the new members, openness of the decision-making process, and less reliance on extensive hearings, the staff became more visible. As the staffers continued to increase and became more visible, the perception and reality of staff influence increased.

On the Senate side, the openness of the process had a major effect on the role of the staff. Since the Senate traditionally worked from the House bill and the JCT staff was familiar with the bill's provisions, the relevant background, and the Ways and Means Committee's deliberations, the JCT staff's role and knowledge made them more visible during Senate consideration.

Effect of 1980 Congressional Elections

Following the 1980 congressional elections, there were new chairmen of the tax-writing committees and major staff changes. First, almost completely new majority staffs, with strong technical capabilities, were put together for each committee. Also, as a result of having a new Republican president and a new Republican Senate, partisanship began to develop in general and particularly on tax issues, starting with ERTA. As a result, the chairmen relied on the committee staffs to a greater extent for partisan alternatives and relied less on the traditional use of the nonpartisan JCT staff.

The JCT staff's role, however, was still important because of its institutional knowledge and the general respect for its technical competency and nonpartisanship. In addition, the need for revenue estimates became increasingly more important; this role continued to be exclusively in the domain of the JCT staff for the tax-writing committees.

The continued pressure to raise revenues because of the budget deficits in the 1980s also had a significant impact on the role of the congressional staffs. Revenue acts began to come year after year; even when there was no revenue act during a year, there usually was a major tax bill considered, since some bills took two years to be enacted.

The multitude of new provisions and complexity of the legislation during the 1980s started taking its toll on the process. Members had previously been used to focusing on major policy questions, but now there were fewer such issues. Legislative proposals were revenue-driven and therefore more detailed; highly technical aspects of the tax laws began to be considered by the committees. Thus, greater burdens fell on the staffs to make recommendations and take a lead on policy, particularly because the administration's opposition to revenue raising meant that the Treasury staff's ability to participate was

curtailed. This is one reason why, at the final stages of consideration of a bill, either in the committee and particularly in the conference, decisions were based on listings with revenue numbers rather than policy descriptions. Since the revenue need has become the principal driving force in the decision-making process and the level of detail can be extremely complicated, the members have frequently found it very difficult to analyze fully the details of provisions.

Relationships With Treasury Staff

Historically, there had been a close working relationship between the staffs of the JCT and the Treasury Department; in the past, however, the Treasury had little direct contact with the staffs of the Ways and Means and Finance Committees. Treasury's role was to initiate recommendations and to advocate its tax policy positions; the JCT staff gave technical advice to Congress (including alternatives to Treasury proposals) without taking stands for or against positions. The JCT staff does make recommendations to the chairmen and often submits suggestions to the committee for consideration, but in the formal markup sessions, the traditional role of that staff has not been that of advocate.

In the 1980s, these relationships shifted. As each tax-writing committee developed its own tax staff and with Republican control of the Senate, the role of the Treasury Department changed. Treasury's posture was also affected by the partisanship that developed in both Houses. This put pressure on Treasury to work more closely with the Republican Senate Finance Committee, or so it was commonly perceived. The working relationship with the JCT staff was no longer the same because of the emergence of more active tax-writing committee staffs. Although the relationship between the Treasury and JCT staffs was still good and there was still coordination on technical matters, the broader policy initiatives were diffused to a great extent and, for the first time, being considered by the committees' tax staffs.

Another significant factor that affected the Treasury Department was the administration's posture on tax legislation. When President Reagan indicated that he would neither propose nor support any measures that raised revenues, this limited the role of the Treasury Department in the initiation of tax matters as well as in the general legislative process. As a result, the chairmen and the committee members looked less to the Treasury Department for guidance, which put more pressure on the committee staffs.

As indicated previously, the role of the tax-writing committees' staffs has grown significantly, primarily as a result of partisanship and the reduced role of the Treasury Department in revenue-raising matters. Whereas the JCT staff used to have the close working relationship with the chairmen, the committee's staffs have now assumed that function to coordinate tax bills before their respective committees. The JCT's role is still crucial, but primarily for technical support (because of the staff's expertise and institutional knowledge) and revenue analysis.

Role of Members' Staffs

The role of the members' personal staffs (legislative assistants) has increased significantly. As revenue-driven tax legislation is being considered more frequently, with all areas potentially on the list for base broadening, the technical complexity has required most members to rely more heavily on their staffs. As a result, the legislative assistants have become heavily involved in the process. Businesses that would be affected by proposed changes, and their lobbyists, find it necessary to meet with the member's staff as well as with the member. In many cases, a legislative assistant takes the pressure off the member from the outside world, but adds another layer of involvement into the legislative process.

Legislative assistants have been given responsibilities for attending hearings, particularly if the member cannot be present, and keeping the member informed of developments at all stages of the process. In some cases, close relationships have developed between some legislative assistants and outside interests, particularly with regard to an issue his or her member supports.

Role of the Chairman's Mark

In the past, the tax-writing committees, particularly the Ways and Means Committee, generally developed legislation by consensus, with few formal votes. In the Finance Committee, where more frequent votes were taken, the final count was held open so that absent Senators could vote; thus results on particular items could be reversed up to the final vote by the committee approving the bill. For drafting purposes, the members made tentative conceptual decisions. The language of a bill was drafted in the Legislative Counsel's office and then brought back to the committee for final consideration, this time on the legislative language. As staff read through the bill, they pointed out to members the specifics of drafting decisions that had been made. The committee, of course, did not study the language word for word, but rather had the opportunity to review their decisions as the staff outlined the bill. In addition, this process afforded the staff the opportunity to present issues to the committee that may have arisen during the drafting sessions.

On a number of occasions in the 1980s, the chairman presented a "chairman's mark" for consideration by the committee at the outset of the markup sessions. The mark consists of the Chairman's recommendations and is generally developed by the majority staff. Thus, the initial decision making is done by the staff, in consultation with the chairman, before the committee meets on the bill. This process, in effect, requires members to make proposals formally to add, delete, or modify provisions in the chairman's mark. This procedure greatly adds to the influence of the majority staff.

Role in Revenue Estimators

In the Past

When proposals were initiated by Treasury, they were usually accompanied by revenue estimates so that the committee knew the general magnitude of each provision and the overall revenue gain or losses from Treasury proposals. Because the legislation was not revenue-sensitive, the committee rarely focused on revenue effects until after the first round of decisions. Since most pre-1980 tax legislation involved tax reductions (essentially returning the "inflation tax," or "bracket creep," back into the economy), the committee made its decisions without specific revenue estimates. After the decisions, the JCT staff determined how much revenue was raised (as in the 1969 and 1976 tax reform bills) or was available for distribution.

Revenue estimates were made by the JCT staff in consultation with the Treasury Department. Since revenue consequences were rarely the controlling issues, there was little concern about revenue estimating until the middle 1970s, when issues such as capital gain rate reductions focused on the question of "static" versus "dynamic" estimates.

Today

In the 1980s, revenue became central to the process; the fate of many proposals depended on how much revenue they would raise, rather than on tax policy or complexity. During consideration of the TRA '86, the committees determined tentative rate schedules and then made the tax reform decisions to raise the revenue; this put tremendous pressure on the revenue effects of the decisions. The revenue consequences of the deficit reduction bills seem more crucial than the policy changes.

Outlook

In 1986, there were about 500 revenue estimates requested by committee members; in 1989, there were more than twice that many. Since the proposed changes have been very technical, added burdens have been placed on the estimators. Thus, the sheer numbers of revenue estimates, the short time for their completion, and the complexity of the provisions suggest that this part of the process is getting dangerously close to the saturation point.

Statutory Language

The statutory language of the committee's decisions is drafted in the House and Senate Legislative Counsel's offices, which are nonpartisan drafting services for the congressional committees. Each has the responsibility for translating its committee's conceptual decisions into statutory language and is assisted by the committee staffs and the Treasury Department.

In the past, the legislative process was very conducive to the formulation of statutory language. Treasury submitted drafts in advance, and the committees' markup process was not constrained by time pressures, which allowed more time to draft. But more important, the policies reflected by the Committees' decisions were more basic and did not require the complicated statutory language that has been required over the past several years.

Today, as the decisions become more and more complicated and greater pressure is applied to the process, allowing less drafting time, the statutory language has become enormously complex. Although some argue that regulations-type provisions are being drafted into statutory language, the problem is more that the legislation reflects, in many cases, the uneven levels at which the committee decisions are made. When the provisions are further fine-tuned for revenue purposes, these types of detailed technical policy decisions are the result.

The basic problem is that in the end the drafting is subordinated to the necessity of reaching revenue targets, and does not necessarily reflect sound tax policy. In fact, there have been instances in drafting sessions when the question was whether to draft a provision based on the committee decision or on the revenue estimate given the committee, if there was a difference.

Staff Role as a Result of Tax Complexity

With more staff, a reduced Treasury role, an increased role for committee staffs--along with a modified JCT staff role, revenue-driven tax bills, tight time schedules, and growing complexity--the entire process has changed radically.

The drive to generate additional revenues has become so intense that it has required repeated reviews of the tax laws to make progressively more technical and limited changes at levels that the committees have never previously considered. These have included the types of changes that before were either done in drafting sessions to carry out the committee's broader policy decisions or, in some cases, made administratively in the regulatory process. As the proposals have become more complex, and the pressures for revenue have increased, it has become easier for members to focus primarily on the revenue that is to be generated. This has resulted in more decision making at the staff level because of the technical nature of these proposals.

Role of Taxpayer Representatives

The term *taxpayer representative* includes a broad range of advocates, but generally means lobbyists who represent special interests before Congress and the administration. Although by far the most visible lobbyists generally represent business interests, these are not the only groups that represent special interests and contribute to the complexity of the tax system.

In theory, the congressional tax-writing committees and the administration are expected to focus on social and equity issues that affect individual taxpayers. There are influential organizations (or so-called public interest groups), such as the American Association of Retired Persons that speak on behalf of individuals.

In addition, smaller businesses such as sole proprietorships, partnerships, and subchapter S corporations are represented by groups like the National Federation of Independent Businessmen. Medium-sized and fast-growing firms are represented by groups like the American Business Conference, while the country's largest companies are represented by organizations like the Business Roundtable. General business groups that serve a wide range of business interests include the U.S. Chamber of Commerce and the National Association of Manufacturers.

Trade associations have become increasingly important in recent years as companies with similar business lines seek to band together to represent their members on broad industry issues. Associations are most effective when the industry is united on a given issue. However, because of the broad diversification that has taken place among U.S. businesses, it has become increasingly difficult in recent years for trade associations to represent their entire membership on other than the most basic items of concern to a particular industry. Frequently, these lobbying efforts involve grass roots campaigns that seek to bring pressure to bear on one or more members of Congress because of significant constituent concerns.

Treasury's Role in the Lobbying Process

Even those who are lobbied become lobbyists on occasion. For example, when the Treasury Department puts forth a tax proposal (such as the tax reform initiative of the mid-1980s or the capital gains reduction urged by President Bush in 1989) the Treasury Department lobbies members of Congress to support their positions. In addition, Treasury generally participates in markup sessions in the House and Senate tax-writing committees and in conference sessions, actively taking positions for or against various proposals.

Individual members of Congress also lobby each other for votes that will help their constituents, and will seek to influence Treasury's implementation of tax laws through regulations if the Members believe Treasury is incorrectly or unfairly interpreting a legislative change that will adversely affect a constituent.

In the Past

Prior to the 1980s, Congress focused on major areas of the tax system over a lengthy period of time before making changes to existing law. Congress indicated far in advance the areas it planned to study, allowing businesses to present their arguments and modifications on particular proposals at the appropriate point in the process.

Many companies believed that direct lobbying was not appropriate for them, and therefore, they were less visibly involved in the lobbying process. In many instances these companies relied on trade associations and other groups--generally, high-visibility lobbyists--that were active in Washington to lobby their issues. For many companies it was generally not consistent with their corporate philosophy to engage in lobbying-type activities under their own name.

Thus, major trade associations--particularly in such areas as real estate, financial services, and oil and gas--took the lead in attempting to influence the legislative process, particularly in the major tax reform bills of 1969 and 1976.

In the 1980s

With the changes that occurred in the early 1980s businesses realized that they could have a more immediate impact on tax law changes. At the same time, businesses and business groups found themselves scrambling to protect not only the gains they had realized in ERTA but also other provisions in the Code that had been enacted to encourage specific economic activities.

Business began to see that it was necessary to deal directly with Congress, or to form coalitions to deal with Congress, to defeat proposals that arose in 1982 and that were likely to be raised in future legislation as well. An increasing number of corporations realized that they had to become more active in Washington--either individually or through trade associations or ad hoc coalitions--to protect their interests and to make sure that members and their staffs were fully aware of the impact a particular tax law change would have on business constituents. In addition, many companies began hiring lobbyists to represent their interests in Washington, not only on current issues but on issues that might arise in the future.

The process no longer included an announced listing of proposals to be considered in a lengthy hearing and markup process. Thus business had to be prepared in advance to anticipate proposals that would adversely affect their operations.

Many business advocates generally represent a particular company directly. They may include the tax directors, controllers, or vice presidents of finance and, if the issue is significant enough, may even include the chief executive officers of large companies. In addition, many of the nation's largest businesses maintain Washington offices, whose government representative staffs deal directly with Congress and the administration on a wide range of issues--including taxes.

Furthermore, businesses will frequently hire firms established to represent business interests before the administration or Congress. These lobbying firms have both technical expertise and contacts or personal relationships with members of Congress, which gives them the opportunity to affect proposed legislation or regulations as they work their way through the system.

Businesses also have used temporary coalitions made up of representatives of diverse industries that have similar tax problems, to seek the best treatment before Congress and the administration. In this way they share costs and have a broader constituency to accomplish their objectives. These coalitions will often hire lobbyists who work jointly with company representatives to represent their interests.

Thus lobbyists may work directly for a business or may be members of trade associations or law, accounting, or consulting firms with special expertise in particular subject areas and with access to members of Congress and the congressional and administration staffs.

Access to Members and the Influence Of PACs

In most cases, the important advantage a lobbyist brings to business is access to key policymakers and the ability to present the special circumstances of a business as legislative or regulatory changes occur. In fact, many lobbyists are former members or key staffers of Congress or the administration.

The amount of access a lobbyist commands has been aided in part by changes in the 1970s that allowed companies to form political action committees (PACs), which collect political contributions from those who work for the company. PAC members may earmark their contributions for particular candidates, but generally allow the PAC to determine which members of Congress will receive contributions. Although federal law generally limits PAC contributions to $10,000 per member for a two-year cycle, the corporate PAC has become a substantial campaign financial source for members.

In addition, honoraria for speeches and papers provides members of Congress with outside sources of income. (In 1989 the House acted to ban, and the Senate to limit, further honoraria members may accept.)

Thus, PACs that can afford to make political contributions and companies that will pay honoraria to members may, in effect, gain limited access to members because of their support. This is not to say that members are swayed as a result, but they are more likely to listen to the arguments the contributors bring to them. It is unlikely that a member who opposes the view of a particular lobbying group will change his or her position because of a campaign contribution or payment of honoraria, but members who have not made up their minds are more likely to listen to the arguments their supporters bring to them.

Activity of Business Lobbyists

With the rapid pace of tax legislation over the past several years, business representatives had to anticipate potential attacks on issues of concern to them. Since business representatives were unable to reach the congressional tax writers through the hearing process, members and staffs had to be educated on how provisions applied to businesses. This meant business lobbyists had to get to know the members and staffs and set up individual meetings to explain their particular views on various tax proposals.

Because these issues have become more and more complex, members have turned over greater responsibilities to both personal and committee staffs. Therefore, a major dialogue has taken place, and continues to take place, involving lobbyists, the staffs of the members, and committee staffs. The role of the hearing process has been replaced by a deluge of meetings with members and staff to make sure that the taxpayers' cases are fully understood.

Effect of Complexity

Lobbyists have had to choose between (1) either arguing against any change in current law altogether and taking the risk of losing that argument or recognizing that some modifications are likely and (2) finding a way to minimize the negative effects on their business activities.

When the second option is pursued, as it is more and more frequently in this era of tax legislation driven by revenue needs, it has had the effect of increasing complexity to an even greater extent. Business representatives seek to fine-tune the Code to provide special rules for an increasingly narrow group of taxpayers. In addition, the proliferation of special transition rules and phase-ins (or phase-outs) of particular provisions of law has obviously added substantial complexity--albeit at the request of lobbyists--to the administration of the tax law.

PROPOSALS: NEED TO MODIFY THE PROCESS

Simplification--Can We Develop a Constituency?

Two things must happen for meaningful simplification to occur. First, a constituency for tax simplification must be developed. Second, the tax legislative process must be changed.

As discussed previously, it is unlikely that a constituency of an influential group of individual taxpayers will ever insist on simplification because most are not affected by the complexity. In addition, the higher-income individuals who are affected not only are not likely to complain publicly but usually have sophisticated advisers completing their tax returns and providing investment advice. Moreover, in many cases the higher-income individuals benefit from some of the more complex provisions.

The business community, in general, will also find it difficult to support simplification publicly. Larger businesses tend to focus tax legislative support or opposition to proposals that are expected to have a bottom-line effect on investment activity. Complexity in the law is a problem for many larger businesses, but it is the stepchild in tax policy and planning. When an issue presents both bottom-line concern and serious problems of administration because of complexity, larger businesses can be an effective voice for simplification. The package of changes to the corporate minimum tax in the Budget Reconciliation Act of 1989 is a good example of a coordinated effort to correct some of these problems.

Small businesses are usually the most effective in successfully advocating repeal of complex tax rules. The recent repeal of section 89, which generated significant interest by small business, is a good example of what this group can accomplish. Nevertheless, even small business groups are not likely to make simplification a high priority.

Because groups outside the technical side of the process are not likely to promote simplification, the constituency will have to come largely from within. Three major groups will have to lead this charge: professional tax advisers, who deal more directly with the system in advising clients; the Treasury Department, which, from its position as regulator and collector, is closest to the system; and Congress, which must be willing to participate and take a lead role.

The next section suggests some ways to stimulate an interest in Congress and to encourage the use of the collegial process among professional tax groups. The role of the Treasury Department is generally outside the scope of this paper, although suggestions for its role in the legislative process are made where appropriate, since Treasury's participation in simplification would be a big contribution to any potential success.

Possible Process Changes to Foster Simplification

There are no easy prescriptions for achieving a simpler tax system, even assuming a constituency for simplification could be developed. Although much concern about complexity in the Tax Code has been voiced, the revenue and timing constraints imposed on the tax legislative process--a direct result of the deficit reduction and reconciliation process--have actually led to greater complexity. Therefore, to promote simplification, significant revisions must be made to the budget and tax legislative processes.

With no effective public constituency for simplification, the burden falls on Congress to initiate major changes in the process if the goal of simplifying the tax system is to be achieved. If appropriately implemented, these changes could enhance the budget process as well as the tax legislative process and lead to the initiation of tax simplification projects supported by the tax-writing committees.

To develop a momentum leading to meaningful simplification, the following components of the problem must be explored:

1. *The federal budget process.* The pressure for revenue-driven tax bills must be eliminated or at least reduced substantially.

2. *Increased congressional support.* In spite of the absence of a large, vocal public constituency for tax simplification, Congress will have to take the lead.

3. *The legislative process.* The present time-pressured process will have to be slowed and procedures that will make simplification possible will have to be implemented.

I do not want to pretend that the following suggestions will be easy to implement; they will not. In fact, some may be politically difficult, if not impossible. But if simplification is to be achieved, bold proposals must be made and discussed now so that, over time, intellectual and legislative momentum can be generated and the present direction of increased complexity in tax legislation reversed.

Budget Process

Because forecasted federal budget deficits are high relative to the annual Gramm-Rudman-Hollings target levels for deficit reduction, there will continue to be strong pressures on the entire budget process. Reconciliation of deficits to the Gramm-Rudman-Hollings requirements has been the outlet for this pressure, with sequestration as the threatened deficit reduction alternative.

Prior to Gramm-Rudman-Hollings, Congress and the president could always decide simply to do nothing. But now, because of the constant threat of sequestration, that option is no longer available, and lawmakers are under extreme pressure every year to do <u>something</u>. When combined with the political realities of the budget debate, this means that there is constant pressure to change the Tax Code to produce additional revenues.

Over the past decade, the administration's budgets have generally been treated as "dead on arrival" largely because the deficit reduction proposals were viewed by Congress as politically unrealistic. To the extent the budgets have included some revenue increase proposals, they were minor and essentially have involved excise taxes or trust fund fees. This simply was not acceptable to a Congress that was being asked to make large and sometimes unprecedented changes in spending. President Bush's first budget, however, did include about $5 billion in revenues; the centerpiece of that, however, was a reduction in the capital gains tax rate to 15 percent, which could have generated revenue for deficit reduction in the short term, but in the out years potential revenue costs were controversial.

President Bush, like his predecessor, has strongly opposed raising revenues as a means of reducing the deficit. Nonetheless, during the 1980s--and what would appear to be foreseeable for the 1990s--each time there has been a deficit reduction bill, revenue increases have been a large part of the overall deficit reduction. This is because revenue increases in the form of "base broadeners," "loophole closers," user fees, or tax changes of limited applicability have not been perceived by the general public as tax increases. Moreover, they have taken the pressure off making larger spending cuts that would face widespread opposition or affect particular political constituencies.

Once the deficit targets have been set in the congressional budget process, it has generally been assumed that a portion of the needed deficit reduction would be derived from increased revenues. The amount allocated to revenues has generally been about 50 percent of the total need, with the remaining 50 percent consisting of spending cuts. However, as the numbers were refined, the amount that actually was allocated to the revenue portion of deficit reduction has generally been less, particularly in recent years.

The pressures of deficit reduction, combined with the short time periods during which reconciliation bills have been produced, have strained the tax legislative process significantly. This has resulted in revenue-driven tax bills that have increased the complexity of the tax system enormously. It would appear that this is quite likely to continue in the future, unless changes are made in the budget process.

The following suggestions might be controversial and, in some respects, might not be attainable because of the political dynamics involved. However, it would appear that several of the proposals would not only enhance the budget process, but would clearly benefit tax policy and possibly reduce the complexity in the tax system resulting from revenue-driven tax bills. The following discussion outlines these recommendations and provides a commentary on their implementation and practicality.

Deficit Surcharge

The congressional budget process should be revised to require that, to the extent revenues are included in any reconciliation deficit reduction instruction, an across-the-board surcharge be imposed automatically and without further congressional action. This is not a recommendation that taxes be increased; rather, it is a proposal for a procedure for implementing whatever tax increase Congress determines is required to meet its deficit reduction instruction. The purpose of this procedure would be to prevent complex, revenue-driven tax legislation from being enacted hurriedly to satisfy the budget process.

This would have two major effects. First, the revenue portion of any deficit reduction bill would be simpler. The amount of the "deficit surcharge" would be set and the rates adjusted to meet the current revenue goal only. For example, if $5 billion of additional revenues were required over a two-year period for a deficit reduction reconciliation package, the across-the-board surcharge on individual and corporate income tax liabilities would be about 0.5 percent. (A two-year period is specified in this example because a focus on only the first-year effect of a surcharge would exaggerate the size of the surcharge rate because of the transition in implementation and collection.)

The value of a surcharge is that it could be temporary and could be reduced or eliminated if additional spending cuts are achieved or if additional revenues are raised from other sources (outside of the budget process). This would eliminate the need for the tax-writing committees to produce major tax bills on an annual basis solely to comply with deficit reduction requirements.

The second major benefit of this proposal is that it would put the pressure where many believe it needs to be: on spending. Because there is generally little or no visibility for the revenue components of most deficit reduction bills, much of the political pressure for spending cuts is removed. If the President and members of Congress want to reduce the deficit through spending cuts rather than revenue increases, there would be more pressure actually to make the spending cuts. In contrast, in recent years the revenue portion of reconciliation accounted for a substantial part of the overall deficit package. Because the revenue components have not attracted widespread attention or controversy, pressure to

make greater spending cuts has been relieved, with the result that enormous complexity has been added to the tax system.

A deficit surcharge would have greater political visibility and, therefore, produce pressures for a smaller surcharge. This would mean a more serious effort to find additional spending reductions.

Reduction of Deficit Surcharge. The deficit surcharge could be eliminated or reduced for the current year or in subsequent years as additional spending cuts are made or other revenue is generated (outside of the budget process).

Tax Reform Bills. If Congress wanted to generate revenue by considering tax reform and using the proceeds to reduce the deficit surcharge, this clearly could be done. The objective is to remove this type of legislation from the budget process, in order to eliminate the pressures for revenue-driven decisions and to promote a full tax policy analysis. As a result, by having a deficit surcharge, tax reform and other substantive provisions could be dealt with separately, so that the tax-writing committees would not be under the pressure from the budget committees. Revenues generated after careful consideration of tax bills in a more traditional process of analyzing tax legislation that could be dedicated to reducing the deficit or deficit surcharge would be a bonus.

Other Revenue Sources. Many believe that the probable need for significant future deficit reductions, particularly if social security is taken out of the budget process, could require a major new revenue source at some time in the not too distant future. Since substantial income tax rate changes appear to be precluded for political reasons, many forecast that some version of a broad-based consumption tax will be the next major source to fill this revenue need. This could take the form of a value-added tax, a business transfer tax, or something similar.

A major new revenue source would not only deal with the deficit and eliminate the "deficit surcharge" but would also provide the revenues that could be used to implement substantial simplification in the income tax system. Since many people believe that simplification cannot be achieved without some use of revenues to offset revenue losses that could result from the repeal or modification of complicated provisions, a significant benefit of a new revenue source could be to provide funding for simplification purposes as well as the deficit.

Political Realities. Although this proposal may be viewed as helpful from a budget process and tax policy perspective, I have no illusions that it will be easy to achieve, if at all. It will clearly require something that has been in short supply on the budget recently: political boldness. It probably could be accomplished only if there was a "summit" between Congress and the administration, as well as a bipartisan agreement about revisions in the budget process. It would, however, create enormous additional tensions between the White House and Congress and possibly between Republicans and Democrats. Therefore, it would test whether there is truly an interest in looking to the long-term potential for real deficit reduction while at the same time it would make revenues a less important factor and reduce complexity in the system.

Suspend or Cut Back on Indexing

Although there are certainly arguments for full indexing, it has been an important reason that much of the complex tax legislation of the 1980s has been enacted. This is because inflation now generates smaller increases in tax receipts so that other revenues must be found for deficit reduction. This annually occurring revenue increase was also frequently used in the past to make corrective changes in the tax system. Because it no longer exists, those changes are more difficult to enact.

If indexing were either suspended or cut back until the deficit was lowered, it could contribute to the revenue portion of deficit reduction. Since indexing only applies to individuals, some may insist that consideration also be given to some means of collecting a proportionate amount of revenue from the corporate sector.

Several proposals have been advanced to cover the budget deficits--at least, in part--with an indexing adjustment cutback, such as "CPI-2", which means that those programs with built-in cost-of-living adjustments (including the Tax Code) would not be fully indexed, but indexed only to the extent of CPI growth less two percentage points. This would result in a budgetary cutback on both spending and tax increases. However, because of political realities, some fine-tuning and other adjustments would probably need to be made for the proper balancing.

Two-Year Budget Cycle

It is finally time to consider a two-year budget seriously. A two-year budget would reduce the pressure not only on the tax system but also on all other congressional activities--especially budgeting, authorizing, and appropriating. It also would allow Congress to focus more clearly on the effects of the legislation rather than on deadlines for the annual budget process. The present system is not good for any of the spending and taxing programs because less and less attention is paid to policy and more and more to the budgetary implications of the changes. And we all know that in the rush to meet the annual deadlines, even the deficit implications are often inaccurate or simply wrong.

Increased Congressional Support--A Simplification Constituency

The need for congressional support for tax simplification is crucial. With no obvious public demand for tax simplification, Congress will have to take the initiative and make some major changes in the process if it is going to happen. Why would Congress do this? The annual budget exercise on tax bills is taking its toll on both the private sector and the Internal Revenue Service. Complexity breeds a contempt for the system and the members. Tax compliance suffers. Investment decisions are hamstrung. The Service's job of auditing returns becomes overly burdensome. The specter of many tax years open in the audit process with proposed deficiencies will become more haunting. From a financial viewpoint, both the government and taxpayers will suffer increased inefficiencies. Congress' failure to respond could seriously undermine the "voluntary" compliance system.

If appropriately implemented, the needed procedural changes would not only simplify the system and thus evoke some much needed gratitude from affected taxpayers (particularly tax advisers) and good editorial support from newspapers, but would also enhance the budget and tax legislative processes. In the highly political world of Washington, the importance of this should not be minimized.

Joint Committee on Taxation

The effort in Congress could be led by the JCT, with support from various professional organizations of attorneys, accountants, and others, in a collegial process.

When the JCT was created in 1926, its primary role was the oversight of the Internal Revenue Service in the administration of the tax laws. This function was carried out basically by reviewing certain refunds approved by the Internal Revenue Service. Over time, as the needs for revenues increased, there was more demand for staff work to deal with the technical aspects of tax legislation. As a result, the role of the JCT became primarily one of the providing technical tax staff to both the House Ways and Means Committee and the Senate Finance Committee.

Committee Role. Paragraph (2) of section 8022 of the Internal Revenue Code provides that one of the duties of the JCT shall be the following:

(2) SIMPLIFICATION OF LAW --

> (A) INVESTIGATION OF METHODS -- To investigate measures and methods for the simplification of such [Federal System of Internal Revenue Taxes] taxes, particularly the income tax; and
>
> (B) PUBLICATION OF PROPOSALS -- To publish from time to time, for public examination and analysis, proposed measures and methods for the simplification of such taxes.

In view of this statutory responsibility, the JCT, as a committee, should be the forum in which simplification projects are initiated. The members of the JCT who are appointed by the chairman and vice chairman could develop the constituency within the Congress to get them enacted. Since the committee is composed of the chairmen and ranking members of both the Ways and Means and Finance committees, the leadership of these committees would be in the right position to promote tax simplification in a nonpartisan, collegial environment.

Committee procedure. If the JCT were to assume the responsibility for establishing a congressional constituency for tax simplification, appropriate procedures could be developed for it to carry out this responsibility. For example, the committee could meet at the beginning of each session of Congress to review possible simplification projects recommended by the staff and Treasury. The chairman and vice chairman may wish to appoint a task force of committee members to review recommendations. A format could

be developed for each proposal, including the reason for the provision, the nature of the complexity, and proposals for simplifying it that are consistent with other tax policy objectives. Revenue effects would not be considered until after the initial draft recommendations were made for the committee's review.

The JCT could issue a report on each project, which would then be referred to the tax-writing committees for legislative consideration under the regular process.

The JCT could be expected to meet several times a year to review the status of the projects.

Staff and Treasury Role. The JCT staff would be responsible for leading the simplification projects, in coordination with the staffs of the two tax-writing committees. In addition, the Treasury Department should be an active participant in the staff work and, along with the Internal Revenue Service, could be responsible for identifying areas for consideration and initiating much of the background and analysis.

Outside Professional Role (Collegial Process)

This proposal anticipates that the Tax Section of the American Bar Association (ABA) and the Tax Division of the American Institute for Certified Public Accountants (AICPA), along with other interested professional groups, would participate in the process in a manner similar to what had been initiated in the 1970s: the collegial process for tax simplification. This coordinated effort among the professional groups and the congressional staffs has worked very effectively, particularly on two projects: subchapter S and installment sales.

Simplification Constituency

If a version of these suggestions were to be seriously considered by the JCT, a constituency for tax simplification could develop from the top down. In this type of environment, we could begin to make steady progress toward meaningful simplification of the tax laws.

Tax Legislative Process

The changes in the tax legislative process necessitated by the political and deadline pressures of the budget process have added to the complexity of the tax system. If it were possible and practical to return to a more deliberative process for the consideration of tax legislative matters, it could well be that simplification concerns would be given more attention by members of Congress and staff.

In any event, certain measures could be implemented in the tax legislative process to ensure concern about, and a focus on, simplification. Several suggestions in this regard

relate to the roles of the following policy players in the process: (1) Treasury, (2) congressional tax staffs, and (3) a simplification task force.

In addition, modifications to aspects of the tax legislative process itself should be considered in order to focus seriously on complexity.

Treasury

The tax-writing committees could request the Treasury Department to present to them any concerns it has about the complexity of a provision under consideration. If the Treasury knew that the committees were going to request such a statement, it no doubt would give more attention to these concerns and the committees' awareness of the relevant points would be heightened.

Congressional Tax Staff

To further enhance the information the committees receive about complexity issues, the staff could be directed to present its recommendations for the simplification of any proposal under consideration. These presentations should be made both in the written materials prepared for the committees' use in their sessions, as well as in the oral presentations by staff with respect to each proposal during the markup sessions. Once again, the more the members of Congress hear about complexity, the more their awareness will be raised to consider simplification as an objective in their decisions.

A Simplification Task Force

In addition to the Treasury's and staff's roles in raising concerns for complexity in proposals during the process, members themselves should have a similar responsibility.

One recommendation, for example, would be for each chairman and ranking members to name a small task force of members with the sole responsibility of raising or reviewing the complexity issues of each matter considered by the JCT. The chairman of the task force could be a member of the JCT. The chairman of the task force would assign a member of the committee to be responsible for addressing complexity concerns about a proposal during hearings and in markup sessions. The task force would not have a separate staff but rather would use the committee staff. The task force would not have any legislative authority. Its sole responsibility would be to ensure that the committee focuses on the complexity of every proposal at both hearings and markup sessions. With the Treasury, staff, and witnesses aware that this would be an expected part of the process, they would be prepared to deal with these concerns and respond accordingly.

Simplification Concerns in the Process

One major factor causing complexity in tax legislation in this decade has been the limited time in the tax legislative process. This has occurred primarily because of the pressure for revenue-driven tax bills as part of the budget process.

One way to alleviate this problem is to deal with the budget process, and several proposals that do this on the revenue side were addressed previously.

As far as the regular tax legislative process is concerned, more attention could be devoted to the complexities of implementing and administering new tax legislation if the process slowed and if it incorporated some of the foregoing suggestions for the Treasury, staff, and a simplification task force. There are other proposals for the legislative process itself that should also be considered.

Hearings. More time could be devoted to the hearings, and they could be structured in a way that would be more meaningful to the members. This does not mean that there should be months of hearings, as was the case in the distant past, but rather, that a more constructive hearing format could be devised that would focus on complexity as one of the main aspects of the presentations before the JCT.

Since invited witnesses often present useful testimony, the hearings format could center around such witnesses, in addition to the others who request to testify. Two types of testimony from the invited witnesses would be desirable--one that focused on the substance of the proposals, and the other on the complexity of the measures.

One panel of invited witnesses on each major proposal could include representatives of professional associations, such as from the ABA Tax Section and the AICPA Tax Division, to focus mainly on the complexity aspects of the proposal. These witnesses should not have a vested interest in the proposals, so that the members can be given a relatively unbiased view of complexity concerns that should be taken into account in their deliberations.

It may also be appropriate for the committee generally to limit the number of panels and witnesses at hearings to allow members more time to discuss issues, particularly with invited witnesses. In today's environment, with a time clock limiting their presentation, most witnesses feel their testimony is useless and are testifying only to provide representation for their respective interests. In addition, members, as well as staffs, probably don't believe that they receive much from the hearings provide much, other than some opportunity for affected taxpayers to be heard.

If hearings could be more constructive on any particular subject by having fewer witnesses or longer hearing schedules--with at least one panel of invited witnesses focusing on complexity--it might well be that the hearings would prove to be more useful for the members.

MarkUp Sessions. Because of the sizes of the committees today and the speed with which they are being asked to make their decisions, it is difficult to deal with this part of the process. Preoccupation with raising revenues results in tax policy not being given a full hearing.

If there were a voice raising concerns about complexity with respect to a proposal in the markup sessions, there would be a greater likelihood that it would get some attention. If the chairman or members of the simplification task force had the responsibility for raising the question on each provision, the members would know that it would be coming and there would be some discussion.

This, of course, does not mean that on each issue simplification concerns would rule the day, but rather that awareness would be heightened. Thus, with the Treasury, congressional staff, and members raising the concern, it is more likely that momentum for simplification would develop within Congress.

Drafting Statutory Language. If the tax-writing committees were given more time, they would have more opportunity to learn about the implications of the statutory language that taxpayers, practitioners, and the government would have to interpret and understand. In the past, when the staffs had less pressure and more time to devote to legislative drafting, the quality of the drafts was far better.

Over the last fifteen years, significant technical corrections bills have followed each of the major tax acts because there was not sufficient time to be more thorough in the original drafting process. Lengthy technical corrections bills add enormous complexity to the system because of the need to take into account two provisions that are intended to reflect the same legislative intent. In some cases, a pure technical correction blends very easily; in other cases, the additional language changes the interpretation slightly which adds to the complexity.

Every effort should be made to allow more time for statutory drafting by the staff in all phases of the process, including the House, the Senate, and especially the conference. Finishing a conference in the middle of the night with drafts on the entire bill, which is due for final passage on the next day, strains the abilities of the staff. While it accommodates the political expediency of meeting certain deadlines, the tax laws suffer greatly.

In another regard, questions continue to arise as to what extent the statutory language should incorporate operating rules for the particular provisions. Some say that the rules are in many cases too technical in the statute and that more should be left to the regulations. Others say that we need more bright lines in the statute and that leaving too much to the regulations results in excessive uncertainty until the regulations or rulings are issued. There is no easy answer to this dilemma. But it is the complexity of the decision-making process and the speed with which the drafting is done--not necessarily how much or how little is left to the regulations process, in many of the cases--that is primarily responsible for mistakes and complexity in the language.

Those who advocate leaving more to the regulations find it difficult to answer the concern that, many times, regulations are not issued for several years after the act is passed and that there is uncertainty for a long period of time about what the statute really means. In addition, when the regulations do come out, they are often voluminous and complicated, which does not help the process.

Dealing with the concerns about statutory language will require more attention being devoted in committee to the full implications of the decisions. Easy-to-understand decisions will lead to simpler statutory language.

THE ROLE OF CONGRESSIONAL STAFF AND TAXPAYER REPRESENTATIVES IN THE TAX LEGISLATIVE PROCESS

ROBERT N. MATTSON*

INTRODUCTION

Taxpayer representatives and congressional tax-writing staff should be able to work together in various ways to ensure drafting of clear and workable statutory language that reflects congressional intent. Taxpayer representatives understand that the Hill's professional tax staff has some very tough choices to make. Unquestionably, there are arbitrage opportunities, inequities, and distortions in a tax code as complicated as ours. The bright people who are employed as staff by the tax-writing committees of Congress and who have to deal with these concerns need a more open process to obtain information about the wider impacts of the provisions that close off unintended opportunities but also restrict legitimate business activities.

If we are ever to reach the goal of simplifying the U.S. tax system, it will be necessary to reverse the trend that Bob Shapiro describes as the "emergence of the more proactive tax-writing committee staffs." Shapiro comments that "all of these staffers with all their input certainly contributed to the complexity." It will take some time to adopt the "bold proposals" put forth by Shapiro. However, there is a need for a more immediate response to complexity in our Tax Code because of its increasingly negative impact on our economy and the competitiveness of our businesses.

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Focus for an Immediate Response

One of the major causes of income tax complexity is excessive statutory language, which has this unfortunate consequence: The statutory language that is most troublesome to a practitioner is often found in sub-subsections of the Code, which are written to correct perceived abuses or constructed as restrictive rules.[1] This restrictive draftsmanship results in both transactional and compliance complexity. This is what McLure refers to as "derivative backstop" legislation.[2]

While basic backstop rules (the alternative minimum tax, passive activity loss, and interest expense limitations) may be countenanced as tradeoffs among competing objectives, in a mixed income-consumption tax system like ours, McLure makes clear that derivative-type backstop measures are inappropriate in the Code. "Virtually every knowledgeable observer would probably agree that the various backstop provisions are exactly that; they are not required for accurate income measurement, they are not transition rules, they certainly do not provide tax expenditures, and they are not just the result of unintended incoherence."

Simplification along the lines of Chairman Rostenkowski's 1989 alternative minimum tax proposal is worth pursuing, and the competing costs associated with such structural changes should be worked out. However, it is not my purpose here to deal with these basic rules.[3]

Rather what is the first order of importance in relieving complexity is the need to refrain from overly detailed language designed to close perceived "loopholes," which is better left to administrative regulation and rulings.

My role today is to comment on Bob Shapiro's thoughtful paper, "Complexity in the Tax Legislative Process." Shapiro doubts that less statutory language can be achieved because of the "pressure for more, not less, statutory certainty." I find this position at odds with my thesis, which is that more intricate language in the statute leads to greater uncertainty, especially when involving transaction and compliance issues better left to more complete administrative proceedings. Also, if we wait, as Shapiro says, until there is "a vocal constituency for simplification," the job will never be done. It is universally agreed that there is a need, an urgent and compelling need, for relieving the burden of complexity in the Tax Code, and it is time to get on with the job.

The staff of the Joint Committee on Taxation, after TRA '86, did not wait for a "vocal constituency" before putting forth its description of possible options to increase revenues, which was released on June 26, 1987 (291 pages). A similar list of simplification provisions is long overdue.

Besides excessive statutory language, the frequency of tax legislative changes and the influence of revenue estimation adds immeasurably to complexity. Also, attitudes about corporate ethics seem to have spilled over into the tax legislative process and result in further transactional and compliance complexity. I am especially concerned that an antibusiness bias may have affected consideration of legislative decisions and has added to complexity.

Deterioration in the relationship between large corporate taxpayers and Internal Revenue Service agents may be traced to a few multinationals' actions during the 1960s and 1970s regarding "questionable payments"[4] to foreign officials to obtain business abroad. Corporations deducted those payments, which led to the infamous eleven questions (April 1976) and special investigations by the IRS. Suspicions of wrongdoing have never been erased, and they affect dealings between the IRS and large corporate taxpayers to this day. Adversary roles have been exacerbated, and audits have never returned to the period of reasonable relationships that they previously experienced.

More recently the IRS has focused its audit resources (as tax shelter cases are winding down) on large corporate taxpayers as a source of additional revenue, recognizing that recent complex and uncertain tax law leaves a vast opportunity to increase corporate taxes.[5] Similar perceptions began to influence the tax legislative process during the early 1980s.

Shapiro says that as tax legislative hearings took on a less important role and there was a change to open sessions, the role of congressional staff began to increase. On the other hand, McLure suggests that open sessions of the congressional tax-writing committees "reduced somewhat the influence of the Treasury Department and the staff of the Joint Committee on Taxation." I agree with Shapiro, since drafting of tax legislation is never an open process.[6] "Derivative backstop" legislation is written with little or no chance for taxpayer representative comment, and it can be substantially amended in closed sessions of the conference. This is where mistrust of corporate taxpayers has placed an even heavier burden on statutory language. Complexity upon complexity is heaped onto the Internal Revenue Code as a multitude of "derivative" rules find their way into far-reaching statutory language.

One need only read a recent article in the Journal of American Bar Association, Section of Taxation, which "presents in microcosm a picture of what has gone wrong with the tax legislation system . . . The lack of hearings as part of the budget reconciliation process, combined with the inaccessibility of Treasury and Congressional staff personnel, made it impossible to carry out a dialogue to develop a solution to the staff's concerns."[7] This is one of the major problems that needs to be addressed. Shapiro rightly points out that the member hearing process has deteriorated. The perception is that statements of taxpayer representatives "are just filed away" and that, if you really want to get your message across, you have to meet directly with members and staff.

Shapiro sees "the role of the hearing process has been replaced by a deluge of meetings with staffs to make sure that their cases are fully understood." But limited access to staff has prevented a full and fair understanding of the intricate sublevel provisions aimed at specific transactions to be understood in terms of their wider impact. Often, taxpayer representatives are not even aware of the detailed provisions until after seeing the final language--way too late to have an impact. Taxpayer representatives are forced in brief meetings to accept complexity to gain modification of adverse provisions because of staff reluctance to eliminate language affecting transaction and compliance complexity, which should be left to administrative handling. If we could soften current attitudes that need rethinking, more rationality would prevail.

FREQUENCY OF CHANGES AND REVENUE ESTIMATES

No matter how complex or simple the language, the frequency of change by itself adds an exponential order of complexity and uncertainty in economic decision making. Repeal, revision, extension, and reinstatement are the terms of chaos in tax legislation.

While sometimes, common sense prevails and reversals of legislative complexity occur, champions in Congress are elicited and further more intricate complexity in statutory language is written into the statute, leading to "guerrilla warfare tactics".[8] Even when cheered as the right thing to do, elimination of complexity is seen as the greed of taxpayer representatives.

When the statutory language is replete with narrow, restrictive "derivative backstop" language, it inevitably leads to technical correction. Taxpayer representatives are equally responsible for the extent of technical corrections, since sometimes a technical corrections bill is the only opportunity for revisions necessary to move a business-motivated transaction forward. In the 1980s there were a dozen significant income tax bills enacted that made sweeping changes affecting every sector of the population and the U.S. economic landscape. And nearly every tax bill contains technical corrections of earlier bills.

In addition, the influence of revenue estimation has distorted the legislative process, so that the numbers, in effect, dictate the policy. The activities and methods of revenue estimators are still relatively secret, but their accountability is increasingly questioned and their influence remains undisputed. "It is the revenue estimators that determine which proposals will be given serious consideration, and all legislative strategies are shaped in part by the estimates."[9] For every bill that is passed, hundreds of bills are introduced for which members would like revenue estimates.

Shapiro suggests that the intricate sublevel targeted legislative provisions can be scored by microrevenue estimates and therefore the budget deficit compels derivative backstop legislation. It has become more and more evident that feedback effects, as well as the static effects, cannot be even closely estimated. Estimating these derivative provisions misleads the members and causes needless complexity. Does any reasonable person really believe an estimator can score the effect of a microprovision like section 404A(d)(1)(A)(i) in footnote 1, or section 514(c)(9)(B)(vi) in footnote 7 of this paper?

Comments from staff members attribute the sometimes questionable results of revenue estimates to two factors: the lack of time and the unavailability of accurate information within that narrowly defined time frame. It is time that the underlying economic assumptions, including feedback effects, of revenue estimates are shared with taxpayer representatives. Revenue estimates should become what they were intended to be, a policy tool, and members of Congress would be better served if they understood the difficulty and error factor in revenue estimation and that the process was open to public scrutiny.

COMPLIANCE COMPLEXITY

One way to measure the effectiveness of the legislative process is to examine the administration of the rules by the Internal Revenue Service and the price of compliance by U.S. taxpayers.

Since 1986, large corporations have experienced an increased burden and cost of data collection, increased computer and software costs to satisfy intricate requirements, and the need for increased tax compliance personnel. Also, there is a significant increase in the degree of frustration regarding tax return preparation time, in the lack of sufficient guidance, and in overall complexity. Taxpayer assessment of the burdens and administrative costs of complying with recent legislation has served as a "mirror" to the increased personnel needs and other administrative costs now being experienced by the Internal Revenue Service in its enforcement and regulatory responsibility under TRA '86.

As reported in the Wall Street Journal, Neil Wissing, Vice President of Taxes of Weyerhaeuser Company, speaking before the Commissioner's Advisory Group concerning the compliance impact of TRA '86 on his company's U.S. corporation income tax return, stated that his staff of forty needed 75 percent more time than before to complete the return and spent 50 percent more time analyzing changes in the tax law for which IRS was unable to give guidance.

IBM does business in over 120 countries throughout the world. The increased burden in worldwide data collection and the complexity of the recent rules relating to foreign-source income in the 1986 Tax Code has been extreme. Additional data requirements have placed enormous burdens on IBM's foreign country financial people. In the United States, IBM has been forced to increase the number of its professional tax staff devoted to compliance by approximately 44 percent since 1986. IBM is not unusual in this increased burden and cost, which can only have placed a competitive disadvantage on United States-owned businesses at a time when it can least be afforded.

Some of the more troublesome compliance issues that all U.S. multinational businesses have faced include the proven unworkable employee benefit tests, the enormously expanded labyrinth of foreign-source income restrictions, and the inventory cost rules which are not in accordance with acceptable accounting guidelines. The following examples demonstrate the needless complexity in the Code and are measures far beyond what was needed to correct perceived abuses.

Nondiscrimination Tests Applicable to Employer-Provided Medical and Other Benefit Plans

The most discredited piece of tax legislation in memory is section 89. Senator Dole noted in response to a storm of negative public criticism that the "compliance costs are now estimated to exceed even the substantial tax revenue raised by section 89 itself."[10]

Section 89 was an attempt by Congress to ensure that employer-provided welfare benefits are extended to lower-salaried workers on a basis comparable to those provided for highly compensated employees. No one disputed this socially desirable objective, but the means chosen to achieve it was an administrative nightmare and could have had the opposite effect. Section 89 provided complex participation tests that employee benefit plans had to meet to qualify for tax benefits.

The tests were so complicated and the required record keeping so burdensome that the rules were made unadministrable, and the cost of compliance alone was estimated to be billions of dollars per year.

Many smaller companies were unable to cope with the costs and complexities of the tests and were discouraged from offering benefits at all. Larger companies would have lost flexibility in their plans and might have had to cut back on existing benefits or refrain from offering new ones. IBM had expended nearly 1,000 man-hours complying with the test data requirements by the time it ended the effort pending repeal of the sections. It is important in this context to understand that IBM provides the same benefit plans to all of its regular employees without exception and without preference for higher-salaried employees.

Passive Foreign Investment Company

Congress was concerned about the incentive for U.S. investors to make investments abroad and obtain a substantial tax advantage vis-a-vis investors in domestic investment companies.

To remedy this situation, a complicated set of rules was enacted by which shareholders in a passive foreign investment company (PFIC) would be subject to current taxation on such investments. The problem with this legislation is that it defined a PFIC very broadly to mean any foreign corporation if 75 percent or more of its gross income is passive income or 50 percent or more of its assets are assets that produce passive income.

Unfortunately, the statutory language failed to limit the impact of this provision to its intended purpose. It was so broadly drafted that it included active controlled foreign corporations (CFCs), usually 100-percent-owned subsidiaries of United States multinationals. The CFC's passive types of income result from normal business activity unrelated to investment company investments. These normal activities include accumulating necessary operating capital (1) to run the business or build additional competitive capacity, or (2) as a result of local country laws requiring specific funding of programs such as retirement plans.

PFIC requirements were first to be met in 1988 with the filing of the 1987 corporation income tax return. On February 26, 1988, IRS Notice 88-22 and temporary regulations were issued, including a requirement that a qualified electing fund (QEF) election was to be filed by March 14, 1988.

The election was required for each foreign subsidiary and had to be signed by its officers under penalties of perjury. Ten days later, Notice 88-31 was issued modifying the QEF election to allow the U.S. parent company officers to sign the election, with a follow-up ratification by the foreign entity by December 15. However, eight days before the required ratification, Notice 88-125 advised taxpayers that any QEF election filed as of that date was nullified that is, "would have no legal effect". This procedural mess is but one example of the total confusion the statute has brought about at the IRS.

De Minimis Rules

Another of the "lesser of" rules in the Code is found in section 954(b)(3)(A). Under pre-1986 law, if less than 10 percent of a foreign subsidiary's gross income was passive-type (subpart F) income, it was not subject to accelerated tax treatment.

The de minimis exception was changed to the "lesser of" 5 percent or $1 million dollars. The $1 million threshold is so low that it affects the compliance costs of all United States multinationals. Every single foreign operation must now be analyzed to determine the amount of separate basket income.

Since 1986, in the foreign-source income area, taxpayers have uniformly observed the exhaustion of intellectual and other resources to comply with the new rules. Major accounting firms have been at a loss to develop adequate computer software programs that provide their clients with a compliance tool to meet the new foreign "basket" and "allocation" requirements.

No matter how resourceful and genuinely desirous of complying, large multinationals using their best efforts have serious concerns about the accuracy of their tax liabilities, whether underpaid or overpaid. Problems of great magnitude are anticipated when Internal Revenue Service agents begin their audits of post-1986 tax years. Well-intentioned critics of the legislative process are asking whether the income tax, especially the corporate income tax, in the United States has been made unworkable and should be abandoned.

CONCLUSIONS AND A PLEA TO RETURN TO A RATIONAL PROCESS

It should be evident from my comments that I am in agreement with McLure's "more radical proposal" for a solution. Clearly, elected members of Congress have neither the time nor expertise to deal with "derivative income definition rules, derivative tax expenditure rules, derivative backstop rules, or technical changes needed to bring coherence to the law."

What has occurred is a growing legislative staff assumption of the proper role of administrators at the Treasury and IRS. Congressional staff are writing transactional and compliance regulations into statutory language without appropriate taxpayer representative hearings or an open process. When regulations arise at Treasury, they are first proposed;

then, comments by taxpayer representatives are received, followed by hearings and then final regulations. I fully agree with McLure's position that between the staff of the Joint Committee on Taxation and the Treasury Department, "it seems clear that Treasury (in conjunction with the IRS) is the appropriate choice" to deal with complex business or perceived tax-motivated transactions.

It is difficult to make specific recommendations about a process that needs more fundamental change, and Shapiro has done an outstanding job in addressing these in his "bold proposals." He has made his proposals in the context of widely agreed-upon reasons for complexity: income definitional problems, incentives and basic backstop provisions. But much of the complexity I have described is found in arcane language dealing with derivative issues that should be eliminated from the Tax Code. Even if we stumble on finding ways to simplify the more basic rules that Shapiro addresses, I believe much progress can be achieved in removing the "deadwood" (voluminous, derivative) rules from statutory language. In this vein I offer some less radical thoughts that would provide immediate improvement to the problem of complexity.

1. First and foremost, avoid the seemingly expedient rate increase approach to simplification. Rate increases or surtaxes make transactions uneconomical, result in competitive losses for United States-owned businesses, and most unfortunate, lead to further complexity as the need for incentives and exceptions filters into the Tax Code to avoid these consequences. I part company with both Shapiro and McLure on this point. To require simplification to be directly tied into a revenue-raising bill has the result of being "ground ruled" into complexity. Simplification then becomes merely a stalking-horse for a tax increase. As a purely deficit reduction measure, Shapiro's proposal for an indexing adjustment of both spending programs and the Tax Code (CPI-2) would not result in the complexity that his "deficit surcharge" would entail.

2. Open up the revenue estimation process to public accountability. It is my perception that this has already begun and it should be continued and expanded. Revenue estimators call taxpayers more often today to determine the static effects of proposals and from time to time have shared revenue estimate information in private meetings. Nevertheless, the revenue guessing at microlevel sections has not seemed to improve and should be eliminated.

3. Provide regular on-the-record meetings between the Joint Committee staff and taxpayer representatives (such as the Tax Executive Institute or Financial Executive Institute). A round of kickoff meetings aimed at obtaining a comprehensive list of options for simplification of the Code should be the first agenda item for such meetings. In this I am in agreement with Shapiro that a simplification project should be initiated by the Joint Committee staff with the support of taxpayer representatives and professional groups in a collegial process.

4. Develop a legislative process in which the tax-writing committee staff present an analysis of the proposed provision's administrability and its impact on the competitiveness of United States-owned businesses worldwide. This may require an on-site IRS liaison representative working with the Joint Committee staff.

5. Reexamine the need for "lesser of" rules in the Code. (A LEXIS search showed that the phrase "lesser of" is used 111 times in 87 separate Code sections "or, if lesser" in five sections, and "whichever is the lesser" in three sections.) Also, reduce excessive statutory language by a disciplined approach toward eliminating sub-subsections in the Code. In doing this, distinguish between a basic backstop provision and a derivative one that deals solely with transactional and compliance issues, and institute a system to avoid legislating the latter.

6. Adopt a multiyear tax legislative process. Instead of a new bill every year, legislation should be written in year 1 with effective dates postponed until years 2 and 3. In that way, more sunshine can be applied to tax law rather than the immediate implementation of flawed provisions. This will also allow an orderly technical correction process before rather than after the provisions' effective date. Consultation between staff and taxpayer representatives will likewise benefit from a multiyear process. Shapiro's proposal for a two-year budget cycle is a complementary proposal.

7. Begin consideration of a major restructuring of the 1986 Tax Code toward a lower-rate-of-cash-flow, consumption-based tax system adopting expensing of intangible and tangible capital assets, eliminating interest from the tax base and leverage issues from statutory provisions, and integrating corporate and individual taxes. It is important that this study not interfere with the immediate consideration of a list of tax simplification proposals.

Again, I fear that I am in agreement with McLure's model on this last recommendation.[11] Taxing consumption rather than saving may significantly improve our nation's economic position.[12]

In conclusion, much of the excessive statutory language to regulate transactions and compliance is unnecessary, flawed, very restrictive, and so complex as to border on the unadministrable. It is time to cut back on the administration of tax law in the form of legislative language and end the production of thousand-plus-page tax bills year after year. Otherwise, tax compliance in the United States will be unalterably eroded and the competitiveness of U.S. business will be seriously injured. At stake is nothing less than the overall integrity of the U.S. income tax system.

ENDNOTES

[1] Section 404A(d)(1)(A)(i), which is a "lesser of" rule, results in the loss of a full deduction because of a potential abuse of another section that has since been eliminated from the Code. "This additional limitation is imposed in response to the possibilities for distortion of a taxpayer's indirect foreign tax credit which are presented by the present annual system for determining the amount of the foreign taxes paid by a subsidiary which are attributable to dividends paid to its U.S. shareholders . . . This potential for distortion might be eliminated if the indirect credit were computed with reference to the subsidiaries' accumulated foreign taxes and undistributed accumulated profits for all years . . . The impact of this limitation is that such as excess is permanently lost." (Emphasis added.) S. Rep. No. 1039, 96th Cong., 2d Sess. 14 (1980). When, in 1986, the rules were changed as suggested to pooling earnings and taxes, there was no remedy provided.

[2] Charles E. McLure, "The Budget Process and Tax Simplification/Complication," AICPA/ABA Invitational Conference on Reduction of Income Tax Complexity (January 1990.)

[3] It is worth noting that the Tax Executives Institute (TEI) endorsed Chairman Rostenkowski's alternative minimum tax simplification in a letter dated August 31, 1989, to all members of the House and Senate tax-writing committees. TEI urged that the provision be included in the 1989 budget reconciliation legislation. "We especially approve of the deletion of references to the book income treatment of certain items (the so-called book income backstop)."

[4] "There has been a steady stream . . . of the best names in American business, including a substantial number from Fortune 500 list, to Washington to confess their misdeeds of illegal political contributions, improper payments to foreign government officials and other unlawful payments . . . Understandably, the public and government have developed a cynical attitude toward the morals and standards of behavior of American business . . . it was the view of the Section of Taxation, American Bar Association, management that the deficiencies of a relative few, although they number approximately 200 and are giants in the business community, do not warrant the assumption that large numbers of additional taxpayers have been similarly callous or careless in the discharge of their responsibilities under our internal revenue laws. Indeed, not even the Securities and Exchange Commission, which has the responsibility for overseeing the filings under the securities laws of more than 9,000 corporations, has reached such a jaundiced evaluation of the corporate community." Shervin P. Simmons, "The Eleven Questions--An Extraordinary New Audit Technique," *The Tax Lawyer* (Fall 1976).

[5] Although conceding that it includes "a good amount of water," IRS Acting Chief Counsel asserted that large-case audits have $37 billion outstanding, of which the government only recovers between 11 percent and 25 percent. Because of this, he sees the need for devoting more IRS resources to large-case audits. *Tax Notes* 30 (Oct. 1989) 538.

[6] "...much of the real drafting process occurred behind closed doors during the dead of night . . . the various tax staffs of the House Ways and Means Committee, the Joint Tax Committee and the Senate Finance Committee, as well as the staff of the Treasury Tax Legislative Counsel, while virtually invisible to the general public, nevertheless played key roles in the drafting process, since theirs was the task of actually putting the statute into words (a responsibility that carried with it considerable discretionary power in terms of the technical details of the legislation). In fact, from the perspective of the tax lawyer, the staffs were the key to the legislative process, in many instances determining the final language of the legislation." Eustice et al. "*The Tax Reform Act of 1986*" (New York: Warren, Gorham & Lamont 1987) sec. 1.04.

[7] Section 514 (part III, chapter F, "Taxation of Business Income of Certain Exempt Organizations: Unrelated Debt-Financed Income") has five subsections, fourteen sub-subsections, twenty-seven sub-sub-subsections and twenty-six sub-sub-sub-subsections. One of these, Section 514(c)(9)(B)(vi), has three further divisions and is followed by a further qualification in two additional sentences. As predictable this unfathomable rule elicited a law review article of almost forty pages critical of the legislative history of this arcane provision. "One comes away from this history with several disturbing observations. First, the tax legislative process has deteriorated to a point where it is difficult to obtain balanced consideration of a technical provision that has serious economic consequences." A.A. Feder and J. Scharfstein, "Leveraged Investments--A Lesson in How the Legislative Process Should Not Work" The Tax Lawyer (Fall 1988).

[8] Congressman Gradison used this phrase in chastising the National Employee Benefits Institute for lobbying for repeal of section 89 nondiscrimination rules applicable to employer-provided fringe benefit plans. The congressman was followed by a Treasury official, who commented that section 89 repeal will only lead to more complex rules under section 106. Tax Notes (25 Sept. 1989) 1458.

[9] R. Bennett, "Revenue Estimating in the Sunshine," Tax Notes, 11 Sept. 1989, 1285. See also J. Teuber "The Suspicion That Results From the Revenue Estimator's Evolving Role Is Not Easily Overcome," Tax Notes, 8 Dec. 1986, 882, and "Revenue Estimators Play a New Role As Numbers Dictate Policy," Tax Notes 24 (Nov. 1986) 698.

[10] Tax Notes 27 (June 1988) 1584.

[11] Robert N. Mattson, "Comments on Henry J. Aaron's Lessons for Tax Reform'," University of Michigan (Nov. 1989) publication forthcoming.

[12] "The United States never has been able to finance business capital spending (investment) with personal savings alone. Business savings in the form of retained earnings and depreciation always have contributed much more than personal savings. Thus, as corporate taxes are increased, sharply draining retained earnings, it is more difficult to finance business investment." Financial Executives Institute, "Proposals for Future Directions in Tax Policy" (October 5, 1988.)

"Recent tax legislation (TRA '86) has increased corporate federal income taxes sharply, and they are expected to continue rising even more sharply during the next few years. This dramatic shift in the tax burden from the individual to the corporate sector has been due, in part, to a widely held perception that corporations were not paying their fair share of the burden." Gillian M. Spooner and Emil M. Sunley, *The Corporate Tax Burden in the United States* (Financial Executive Research Foundation: 1988). The author of this paper was chairman of the FEI Committee on Taxation during the preparation of these two reports.

COMMENT ON "COMPLEXITY IN THE TAX LEGISLATIVE PROCESS"

RONALD A. PEARLMAN*

I think it probably would be disloyal for me if I don't at least begin with some note of realism, which I will characterize as a dose of reality, and end with some note of optimism.

There is no dispute, believe it or not, among members of Congress and among the staffs on Capitol Hill that the volume of tax legislation particularly over the past fifteen years is not only substantial, but indeed overwhelming. We live with the same Internal Revenue Code you do; we are confronted with it daily, and it is as overwhelming to us as it is to you.

Having said that, I think it is unrealistic to think the tax legislative activity that we have seen is going to subside. First, the federal government needs revenue. If it doesn't need it for deficit reduction, I think we will see it needs it for new programs that are supported both by the President and the Congress and, indeed, by the American people.

Second, there is a continuing interest--we see it every day--in enacting new tax incentives in the Internal Revenue Code. Capital gains obviously is a well publicized one, but also what about enterprise zones, which will be topical this year; child and dependent

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Mr. Pearlman has been active in the American Bar Association's Section of Taxation, and at the time of his appointment to the staff of the Joint Committee, he served as a member of the council of the section. In addition, he served as a member of the Federal Income Tax Project Advisory Group of the American Law Institute, the BNA Tax Management U.S. Income Advisory Board, and the advisory council of the Tax Foundation. Mr. Pearlman graduated from Northwestern University School of Law, and he received an LL.M. in Taxation from Georgetown University Law Center.

care tax credit incentives; broadening the availability of tax-exempt bonds, and health and retirement policy tax incentives?

Third, we are in an activist period of tax legislation. The private sector wants Congress to enact tax legislation. Let me give you some data. It is fairly mechanical data, but it may give you some illustration of what that means.

In 1983 the Joint Committee staff received from members of Congress 150 formal requests for revenue estimates. Those are revenue estimates on member-initiated legislative proposals. Some were to increase revenue, but by and large, those proposals have negative revenue effects and were supported -- and many times, initiated -- by taxpayers or tax practitioners.

In 1985 the number was 348, and in 1986 the number was 474. So, during the height of tax reform, roughly 400 formal requests a year. In 1988 we received 900 requests, or nearly two times what was received in each of the years '85 and '86. And in 1989, I frustratingly report to you that we receive 1,290 requests, and we see no reason to think that the volume of requests will go down in the future.

Not a week passes that we don't hear about a legislative response to a ruling, regulation or court decision that is viewed as inappropriate by a taxpayer.

Further, I think it is unrealistic to think that the answer to the government's revenue needs will be merely to increase tax rates. Politically, members of Congress are not going to regularly vote for tax rate increases. And I would submit to you that from a policy standpoint there is absolutely nothing wrong with continuing to try to accurately measure income in an income tax system and that it should be an ongoing process. There is some inevitable complexity that results, but to say to the high-effective-rate taxpayer, whether it be an individual or a business, "Well, it is simpler to raise your tax rate and ignore the lower-effective-rate taxpayer," is, in my opinion, simply not supportable, either politically or from a policy standpoint.

Now, having said that, complexity in the tax law obviously should be a concern to people in the tax legislative process, and I hope you will accept my representation that it is. That is not to mean it is most of the time representative of what we do; all too often, the staffs, members of Congress, and the private sector don't put simplification of a tax legislative proposal at the top of the agenda, and that should come as no surprise to you. Why? Sometimes there is a policy reason, sometimes it is pure politics, sometimes it is just time.

We have had some successes. In 1988 we enacted a minor provision that permitted parents to include children's income on parents' returns. Our projection is that will reduce the number of childrens' returns filed with the Internal Revenue Service by as many as 400,000--a very substantial reduction in complexity for taxpayers affected by that provision.

I think the alternative minimum tax change in 1989 was a major simplification of the AMT, but I have to tell you candidly that if instead of losing $400 million in fiscal year

1990 that change had raised $400 million in fiscal 1990, it would not have seen the light of day. I give both Chairman Rostenkowski and Chairman Bentsen credit for being willing, in a painful year budgetwise, to take a $400 million revenue hit in the interest of trying to bring some simplification to the alternative minimum tax.

We did some specific things in designing proposals in 1989 intended to try to reduce the intrusiveness of provisions on specific taxpayers. The high-yield debt provision now contained in section 163 was designed to minimize its impact on everyday transactions. The change in the tax treatment of securities under section 351 is, in my opinion, a major simplification. And finally, if you look at the net operating loss carryback, excess interest rule of section 172(b), not only is there a de minimis rule, but there is also a number of other features designed to limit its application in relatively insignificant transactions.

For the future, the challenge to reduce complexity requires a significant effort. Existing law clearly is complex, and we have undertaken a series of projects designed to try to address some of those complexities. It would be wonderful to set time aside, as Bob has suggested, and enumerate 290 simplification projects. I have to tell you the staffs on the Hill, not only the Joint Committee staff also but member staffs, and tax-writing committee staffs, are simply overwhelmed. But I think it is possible to identify discrete projects. My own personal priorities are the personal interest expense deduction and the foreign provisions. I think they are both in need of some serious attention.

I have to be very candid and say that you can simplify the personal interest expense deduction very easily by throwing all interest expense in one basket and making it all deductible and paying for across-the-board deductibility by reducing the percentage of deductibility. And I recognize that the first time I suggest to members of Congress that the home mortgage interest deduction be reduced by three or four or five percentage points to pay for what could be a major simplification of the individual tax system I suspect there would be strong opposition expressed.

The ABA and the AICPA submitted to us some specific suggestions designed to simplify both the individual and corporate income tax provisions. I think those suggestions were very constructive, and we have indicated that in several instances we intend to take a careful look at those suggestions during the year.

I think it is important to keep the process discrete. Only a limited amount of effort can be devoted to simplification projects in any one year, but I think there is a prospect of making some headway.

The real difficulty for us is in the tax legislative process. How do we identify, become sensitive to, and respond to the complexity that develops as new tax legislative proposals evolve? It is a very, very difficult process. Part of the problem is that we don't have time to stop and think about complexity. Part of it is that the design of the provisions is really not in our control very often. Sometimes we get very little outside input. It has always been particularly frustrating to me that we don't get more input even when provisions are out in the public view for some period of time.

Having said that, we do address complexity issues verbally; we talk about the level of complexity; we have made efforts to communicate with the Internal Revenue Service and Treasury and bring them into the process.

I think it is unfair and unfortunate to assert that the complexity of the tax law is something that is not considered important by people on the Hill involved in the tax legislative process. If we appear at times defensive, maybe it is because we are accused of being insensitive; and if at times we appear totally cynical, maybe at times there is some justification.

I can speak for the Joint Committee staff, but I think I can also speak for the other tax staffs on the Hill. This is a subject that is of genuine interest to us and one on which we are happy to work with our colleagues within the government, outside professional organizations, and others to try to make some progress on this challenging issue.

ELIMINATING COMPLEXITY FOR INDIVIDUAL TAXPAYERS: A REVENUE LOSER WITHOUT A CONSTITUENCY?

DEBORAH H. SCHENK*

INTRODUCTION

There is no disagreement about the complexity of the Internal Revenue Code. There is less consensus on how, whether, and at what cost to fix it. This article primarily addresses the first question; that is, it offers discrete suggestions for simplifying the federal tax law as it applies to individuals. The other two questions are so fundamental, however, that depending on the answers, it may be nonproductive to even consider the first. While the answers to the questions--whether to simplify and at what cost--are far from clear, the obstacles they present are apparent.

Lack of Constituency

The issue of whether to simplify arises because it is increasingly apparent that the simplification cause may have no constituency. Although taxpayers universally bemoan the complexity of the law, there is no evidence of grass roots support for meaningful simplification.[1] Specifically, taxpayers appear to tolerate significant complexity in order to eliminate marginal horizontal inequity. More importantly, taxpayers generally are unwilling to sacrifice tax benefits to achieve simplicity.

The legislative and executive branches also seem to be unmoved even by complexity affecting large numbers of taxpayers. Although individual taxpayers are a significant constituent block, they are largely unrepresented. Unlike the timber or real estate industries, the "average American taxpayer" has no lobby.[2] Perhaps Congress is unconcerned because there is no potential revenue gain: A benefit unused due to its

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complexity does not increase the budget deficit. Or perhaps Congress is unconcerned because it also believes that, even with a lobby, the majority of Americans would have no interest in simplicity.

It is possible that this view is overly pessimistic, perhaps even uninformed. There is evidence, for example, that abolition of some benefits in the name of simplicity has been accepted without a hue and cry. Consider the streamlining of itemized deductions through the elimination of certain deductions and the curtailing of others.[3] This observation would lead to the adoption of an accretion approach--that is, to dismantle complexity by attacking piecemeal those provisions likely to have the least ingrained support, rather than attempting massive reform involving sacred cows.[4] It is also likely that taxpayers do not understand the trade-offs involved. Elimination of a tax expenditure is generally viewed as an individual detriment, rather than a systemic benefit. Perhaps taxpayers can be educated to focus on structural gains such as elimination of complexity.

Assuming arguendo, however, that taxpayers, and thus their elected representatives, have no interest in simplification, is there any reason to pursue it as a goal? Although reasonable people can disagree, I argue yes. The pursuit of simplification is a good example of the group benefit theory; individuals may be willing to support a particular action where the group benefit exceeds the individual detriment. A good analogy is to a household chore like taking out the garbage. Although an individual personally might not prefer garbage removal to television watching, he might be willing to impose such a rule on the entire family rather than permit the garbage to pile up. The issue is whether taxpayers view or can be persuaded to view Code complexity as garbage piling up.[5] To carry the analogy one step further, frequently there must be a group leader, like the parent in the family scenario, who can explain or even impose a rule with group benefits. That leadership role has not been claimed by either Congress or the executive. It is conceivably a role for tax professionals.[6]

Revenue

The second major issue to confront before considering discrete simplification proposals is revenue neutrality. Congress is currently operating under a self-imposed restraint which prevents passage of tax legislation which results in a revenue loss. Legislation must either be revenue neutral or must be matched by legislation offsetting any revenue loss. This constraint raises thorny issues in connection with simplification for individual taxpayers. There are four possible approaches which are appraised below.

Revenue neutrality can be achieved by cutting the pie into more pieces.

Most of the potential simplification for low income taxpayers comes from reform of provisions that can be described in the aggregate as providing a support allowance.[7] The dependency exemption, the earned income credit, the child care credit, and the standard deduction are used primarily to insure that a minimum amount of income, needed for support, is not subject to tax. To some limited degree, the refundable earned income credit

provides an income subsidy. To the extent these rules are simplified so that either more taxpayers are eligible for benefits or more taxpayers are able to file a return, revenue will be lost.

This form of simplification easily can be made revenue neutral, but at a significant cost. The amount now budgeted for support allowances through tax benefits can be allocated among more taxpayers. This can be done mechanically by decreasing the amount of the exemption, earned income credit, or standard deduction. While this approach increases simplicity and revenue, it has a detrimental effect on equity. A decrease in the support allowance provisions will bring taxpayers below the poverty line back into the tax system. That is difficult to justify theoretically. One of the clear achievements of the 1986 act was to remove those below poverty level from the tax rolls on the theory that they had no ability to pay taxes. A basic tenet of our income tax system is that the level of taxation should be based on ability to pay. The trade-off is clear: As revenue increases, horizontal equity decreases.

Revenue neutrality can be achieved by not serving pie to everyone

Another approach is to pick up revenue by not providing support allowances to all taxpayers. This strategy has already been used: The earned income credit is available only to low-income taxpayers, and the exemption is not available to high-income taxpayers. The only two remaining options are to limit the standard deduction and to provide a lower eliminated for the exemption. Theoretically the exemption could be phased out for all taxpayers not at the poverty line. This would decrease progressivity, however, and provide a substantial cliff effect. Alternatively, the exemption could be gradually phased-out at levels lower than those currently used. Limiting the standard deduction is more complex. Since itemized deductions are an alternative to the standard deduction, presumably many taxpayers who lost the standard deduction would itemize, resulting in more recordkeeping and complex returns. It is not clear that the trade-off is warranted.

Revenue neutrality can be achieved by offering a smaller pie to others

To some extent this approach is nothing more than a defense of this paper. That is, revenue loss on the proposed simplification for individuals discussed herein might be paid for by revenue gains in areas not within the scope of the paper. As noted below, there are ways to raise revenue from individual taxpayers, but none are wholly acceptable. This approach suggests that simplicity in one area not be considered in isolation. The revenue to pay for simplification of the earned income credit or the domestic relations rules may need to be found in business or corporate provisions.

The right to a slice of pie is not based on the ability to understand the code.

This approach acknowledges that the cure for complexity and inequity is not free. To some extent, particularly in the low income area, complexity results in taxpayers not taking benefits to which they are currently entitled because the eligibility rules are too complex.[8] Alternatively, benefits are foregone when the rules do not carry out theory or

policy, thus cutting off some taxpayers who theoretically are entitled to a benefit.[9] Simplifying qualification standards so that taxpayers may claim the benefits to which they are entitled may result in a revenue loss. This is not revenue to which the government can rightfully lay claim or call foul when lost. Under this approach the cost of curing complexity would not be subject to the usual revenue constraint. It is a peculiar position for Congress and those who speak for it to assert that the costs of reforming a complex law that is neither understood or complied with cannot be borne. Non-inevitable complexity should be addressed as a mistake, and analogizing to the tax benefit rule, any revenue benefit procured through a mistake should be foregone when the error is corrected.

The remainder of the paper lays out a course of action. The second part discusses issues pertaining to low-income taxpayers. The third part discusses domestic-relations tax issues, specifically child support and the "kiddie tax." The fourth part discusses recordkeeping, the most difficult problem for middle income taxpayers. Each section presumes that simplification is warranted. It also presumes that one of the above four approaches to the revenue issue is satisfactory. If one presumes to the contrary, turning the page is an exercise in futility.

LOW-INCOME TAXPAYER ISSUES

Exegesis of The Problem

All low-income taxpayers must determine filing status, the number of exemptions, and the standard deduction. Most also must calculate the earned income credit, and many must determine marital status and the child-care credit. Each of these benefits unfortunately has its own complex qualifying and recordkeeping requirements. For many taxpayers, the tax return and instructions present a bewildering morass of rules which cannot be easily mastered. One consequence is that many low-income taxpayers either turn to professional preparers or fail to comply with the law. In the vast majority of cases, this noncompliance injures the taxpayer rather than the fisc: The taxpayer is usually entitled to a refund due to over-withholding or the earned income credit. Benefits which Congress enacted to provide assistance to low-income taxpayers go unused because the accompanying rules are shrouded in such complexity that the intended beneficiaries are unable to employ them.

This portion of the article is premised on the belief that there are large systemic benefits to be reaped from the simplifying those provisions which affect the majority of taxpayers. It takes three tacks. First, it adopts the accretion approach, suggesting piecemeal simplification to various sections affecting low-income taxpayers. Second, it weighs radical reform. Third, it also recommends that, to the extent complexity is incurable,[10] assistance be provided to taxpayers to enable them to undertake their duty to comply.

Thrust of the Proposals

The primary thesis of this section of the article is that low-income taxpayers should be expected to comprehend the fewest possible concepts, and thus, to the extent possible, definitions and qualifying thresholds should be uniform. The major steps in this process are to choose a concept, tailor it to be as simple as possible, and apply it uniformly to provisions affecting low-income taxpayers.

The proposal utilizes the dependency exemption as the polestar of the system. In a simplified form, it would be used to determine eligibility where the existence of a qualifying individual is required. Unless absolutely necessary, all other definitions of qualifying individuals and eligibility would be eliminated.[11] This would contribute to simplification on two levels. First, a taxpayer without exemptions would have the simplest possible return to file.[12] Second, all other low-income taxpayers would have much less difficulty calculating their tax liability. They would start by determining if they were entitled to a deduction for a dependent; once that question was answered in the affirmative, several other results would automatically follow.

If the dependency exemption is to be the cornerstone of the tax system for the low-income taxpayer, it must be as simple as possible without sacrificing horizontal equity.[13] The next section discusses proposed simplification of the dependency exemption. The following sections track the exemption as the qualifying threshold for marital status, filing status, the earned income credit and the child care credit, and propose further simplifying refinements. The final section considers two more radical proposals which would tolerate some inequity in exchange for significant simplification.

Specific Proposals

Dependency Exemption

The Problem.[14] Use of the dependency exemption as the qualification standard for benefits is somewhat stymied by its extraordinary complexity. The degree of complexity is troubling because of the widespread use of the exemption by low- and middle-income taxpayers: Approximately 50% of all returns filed take a dependency exemption.[15] It is also difficult for the Service to administer because the many factual issues require an allocation of manpower disproportionate to the revenue raised. These factual issues require a level of recordkeeping which is problematic for taxpayers who are generally unaccustomed to keeping records. There is ample evidence that compliance is a problem.

Simplification of the exemption should be a high priority even if it is not used as the basic qualifying test for benefits. Taken together with the standard deduction, the dependency exemption is a major element of our tax structure. The combination sets the income threshold for the imposition of taxes and has a significant effect on revenue. Under the current, relatively flat bracket structure, these twin deductions preserve the-ability-to pay principle. Furthermore, since the proposal uses the exemption to support other significant tax benefits, such as filing status, the child care credit, and the earned income

credit, increasing the equity and simplicity of eligibility requirements for these benefits ensures that they are not awarded in a discriminatory and irrational manner.

Under current law, a taxpayer is entitled to a deduction for each dependent, provided the dependent's gross income for the taxable year does not exceed the amount of the deduction.[16] A dependent must either (1) be a relative of the taxpayer or (2) have as his principal place of abode the home of the taxpayer and be a member of the taxpayer's household for the taxable year.[17] In addition the dependent must be either a citizen or resident of the United States or a resident of a contiguous country[18] and cannot file a joint return.[19] Finally, the taxpayer must provide more than one-half of the dependent's support.[20] Alternatively, the taxpayer may join with others who provide support in signing a multiple support agreement allocating the exemption to a qualifying taxpayer.[21]

Until 1986, the law permitted a potential double exemption: a parent and child who were under the age of 19 or a full-time student could each take a deduction for the child. The Tax Reform Act of 1986 eliminated this possibility by providing that if an individual was allowable as a dependent on the return of another, he was not entitled to his own personal exemption.[22]

Proposal. The important legacy of the 1986 Act is that only one exemption per taxpayer is permitted. Much additional simplification is possible now that Congress has made the political and policy decision to permit a single exemption per taxpayer. Specific suggestions follow.[23]

(1) Simplification of the Support Test. The theoretical underpinning of the dependency exemption is horizontal equity. Two taxpayers with the same amount of income are not similarly situated--and thus should not pay equal taxes--if only one supports a dependent. As a result, a support test is a necessary eligibility requirement for a deduction based on ability to pay. The current rule allocates the exemption to the person providing more than half the support. Where only one person provides support, the rule is easy to apply. Low-income taxpayers are often supported, however, by two or more persons. In that situation, the current rule is difficult to apply.

The proposal calls for an objective minimum amount of support. Where two or more taxpayers provide the minimum amount of support, alternative rules are proposed. There are four tiers which may be viewed as a sieve. The vast majority of taxpayers will use the first simple rule. The other three rules, which are also simpler than current law, apply only where the first rule does not work. They are:

(i) A taxpayer is permitted to take an exemption if he provides as support not less than the indexed amount of the exemption ("exemption amount"),[24] unless a multiple support agreement is in effect.[25] There would be, however, no minimum amount of support required to be provided by a parent so long as no other person provides the exemption amount.[26]

(ii) Where two or more taxpayers each provide the exemption amount of support,[27] the taxpayer with whom the dependent resides[28] would take the exemption.[29]

(iii) Where two or more taxpayers each provide the exemption amount of support and neither lives with the dependent or both live with the dependent, the taxpayer who provides the most support would be entitled to the exemption.[30]

Thus, generally the taxpayer who provides the exemption amount in support for another is entitled to a deduction for that amount. The only exception is for parents, who almost always have a legal obligation to support children. The parent exception applies only when no other taxpayer qualifies; to apply the exception more broadly invites tax arbitrage. Where the parents do not file a joint return and each may seek to take an exemption, a variety of rules apply.[31]

Consider the following examples, all of which assume the exemption amount is $2000:

(a) A and B are married and file a joint return. They have one child; C. So long as no one else pays more than $2000 for the support of C, A and B may take a deduction for C irrespective of the amount of support provided.[32]

(b) Same as *a* except that C's grandmother provides $2500 of support, and A and B together provide $1000. The grandmother is entitled to the exemption.

(c) B1 and B2 are brothers who provide the total support for their mother. B1 provides $4000 and B2 provides $2500.

Since the mother resides with B_2, she is entitled to the exemption for the mother. If the mother resided with neither, B_1 would be entitled to the exemption since he provided the most support.

The last example suggests that taxpayers may desire to allocate the dependency exemption themselves. Since only one exemption may be taken for each individual, such self-ordering should not be objectionable.[33] Under the proposal, the multiple support provisions would be amended so that taxpayers who, in the aggregate, provide the exemption amount of support are permitted to sign an agreement allocating the exemption to one of them. A necessary constraint to prevent tax arbitrage[34] is a requirement that the taxpayer who takes the exemption provide a minimum amount of support.[35] This minimum should be a fixed number.[36]

The proposal does not limit the items to be taken into account in calculating support. The difficulty in agreeing what constitutes support is not worth the marginal simplicity achieved. The Service is also better served by some flexibility.

(2) Elimination of the relationship test. The proposal would eliminate the relationship test as part of the definition of a dependent. This test only contributes to complexity and is not necessary to avoid abuse. There is no tax incentive to contribute support since taxpayers (other than parents) must contribute at least the exemption amount in support.

(3) Elimination of the gross income test. The proposal would put no limit on the amount of a dependent's gross income.[37] If the rationale behind the dependency exemption is to exempt a minimum level of support for each person from the income tax, it is appropriate for the supporting taxpayer to take the exemption so long as no one else is permitted to do so. With the express limitation of one exemption for each individual, there is no longer a need for an income limitation. The government should be indifferent as to who supports an individual. For example, if a parent earns $30,000 and the child earns $10,000, it should be irrelevant whether the parent contributes the $6000 needed for support and the child banks a similar amount, or vice versa.

(4) Repeal of the joint-return test. Abolishing the gross-income test would permit the corollary elimination of the current rule that a taxpayer is not entitled to an exemption if the dependent and the dependent's spouse file a joint return.

Presumably this test was adopted to avoid difficult tracing questions necessary to determine if the dependent exceeds the current income limitation. If there is no limitation on gross income, the source of the income is irrelevant, thereby eliminating the need for the test.

Marital Status and Filing Status

<u>The Problem.</u> Under current law, taxpayers who are single or married filing jointly or separately can easily determine filing status. A taxpayers who is a surviving spouse or head of household must have a qualifying individual. Complexity in connection with marital status is largely a problem of the abandoned spouse. A taxpayer may be married for state-law purposes and single for federal purposes.[38] Under current law an individual who is otherwise considered married (because he is not officially divorced or separated) may be single for tax purposes provided he is "abandoned"[39] and there is a qualifying individual. Qualifying as an abandoned spouse[40] and to some extent as a head of the household is a peculiarly low-income taxpayer problem.

Under current law, an abandoned spouse is one who maintains as his home a household for more than one-half the taxable year which is the principal place of abode of a qualifying child.[41] A qualifying child for this purpose is a son, daughter, stepson, or stepdaughter for whom the taxpayer is entitled to a dependency exemption.[42] Adoption or use of a multiple-support agreement is permitted. A head of the household is one who maintains as his home for more than one-half the taxable year a household which is the principal place of abode of either an unmarried child, a married child for whom a dependency exemption is allowable, or any other related dependent.[43] A child may be adopted,[44] but a multiple-support agreement may not be used.[45] A surviving spouse is a taxpayer whose spouse died in one of the two preceding taxable years and who maintains a household for the entire year for a dependent child.[46] Adoption or use of a multiple-support agreement is permitted. It is not difficult to comprehend why low-income taxpayers find these provisions complex, but it is difficult to ascertain any unifying principle.

Proposal. The proposal is that the only requirement to qualify as an abandoned spouse is that the taxpayer be separated from her spouse for the final six months of the year. To qualify for head of household or surviving spouse status, one must have a dependent as a qualifying individual.[47] Each status is discussed below:

(1) Abandoned Spouse. A federal tax definition of an abandoned spouse is presumably offered as a solution for the low-income taxpayer unable to afford a divorce or separation agreement. Once the decision has been made to offer this extra-legal status, there is no acceptable rationale for the imposition of the requirement of a qualifying individual.[48] Section 7703(b) could be simplified if it provided that the only prerequisite for a taxpayer to be considered unmarried as of the end of the taxable year is that during the last six months[49] of the taxable year, such individual's spouse is not a member of such household.[50] A husband and wife living apart are no longer an economic unit pooling resources and thus should no longer be considered a taxable unit. This reality is recognized in the case of a divorced couple, regardless of whether they have children. To increase both equity and simplicity, the separated couple should be treated identically.[51]

This would eliminate two of the most inequitable situations under current law. One is the case of the low-income couple who separate with only one child. The mother, for example, who resides with the child, is considered unmarried. The father, who has no dependent, is married and thus his status is married filing separately. Even more egregious is the low-income couple who split up without children. Forever unable to afford a divorce, they are forever married filing separately.[52]

Assuming, however, that this simple rule is not politically possible,[53] the alternative is to provide that the qualifying individual be any dependent whether or not s/he resides with the taxpayer. There appears to be no reason why the individual must have a child to establish a state of "unmarriage."[54] Using dependent as the prerequisite would also conform to the notion of a uniform qualifying individual. The next best simplification is to eliminate the requirement that the dependent child live with the taxpayer. The final and least acceptable alternative is to leave section 7703(b) as it is and conform sections 2(a) and (b) dealing with filing status.

(2) Surviving Spouse. The suggested simplification for the surviving-spouse filing status is identical to that proposed for the abandoned-spouse provision: Eliminate the requirement of a qualifying individual. So long as the taxpayer's spouse has died within the preceding two taxable years, the taxpayer would be eligible for surviving spouse status. Put more simply, the benefits of a joint return would be continued for two years after the death of a spouse. Assuming that the existence of the status is good tax policy, why should it matter whether a spouse has left a dependent child?[55]

The second-best simplification alternative is to broaden the definition of the qualifying individual to include any dependent. Although this would apply in rare cases to someone other than a child, it would promote uniformity. A third and less beneficial proposal would be to abolish the requirement that the child live with the taxpayer in a household maintained by the taxpayer. As a practical matter, this requirement probably

effects virtually no taxpayers, but it does add unnecessary language to the Code, return, and instructions.

The least acceptable, but still helpful, simplification is to conform the surviving spouse rules to those for the abandoned-spouse and head-of-the-household statuses. This could be done by requiring that the dependent child live with the taxpayer for only one-half, rather than the entire, taxable year.

(3) Head of household. A qualifying individual is a necessary prerequisite for this filing status in order to distinguish it from the single status. The proposal is to impose a single requirement: that the taxpayer support a dependent. The dependent need not reside with the taxpayer for any portion of the year, although most dependents would do so,[56] and the taxpayer would not need to maintain a household. The proposal would, however, tighten current rules (and possibly raise revenue) in that currently an unmarried child of the taxpayer can qualify the parent for head of the household, even if not a dependent.[57]

If, however, we presume that the theoretical basis for this filing status requires the taxpayer to maintain a household, the section could be simplified by retaining the requirement that the taxpayer maintain household for one-half the year, but requiring the qualifying individual to be a dependent.[58] The current exception for parents could be retained.

The greatest simplification, however, would be repeal of the head-of-household filing status. If the earned-income and child-care credit were keyed to the existence of a dependent, rather than marital status, as suggested below, there is little current need for the additional filing status. The only remaining advantage to the status is the level at which rate brackets change. The 28% rate kicks in at $17,850 for a single taxpayer and at $23,900 for a head of household.[59] If the exemption, standard deduction, and earned-income credit could be combined to provide a true support allowance based on dependents,[60] there would be no reason for varying rate schedules.

Earned Income Credit

The Problem. Under current law, a low-income taxpayer with a qualifying individual is entitled to a refundable tax credit of up to 14% of his earned income for the taxable year.[61] The definition of qualifying individual is linked to filing status. Married couples filing a joint return are eligible for the credit if there is a child for whom the couple is entitled to a dependency exemption.[62] Furthermore, the child must have the same principal place of abode in the United States as the parents for more than one-half the taxable year.[63] If the taxpayer is a surviving spouse, the child must live all year in the United States with the parent who must have maintained a household for him.[64] A head of household, however, may take the credit so long as an unmarried child or descendant lives with the taxpayer for more than one-half the taxable year in a household maintained by the taxpayer. Alternatively, a married child or descendant qualifies, provided the taxpayer can take a dependency exemption for that person.[65] This multiplicity of definitions perhaps explains the high error rate for the credit[66] and the appalling number of eligible taxpayers who fail to claim the credit.[67]

Proposal. There is some evidence that the earned-income credit was originally designed to offset the social security taxes paid by low-income wage earners. It has come, however, to serve a broader function, i.e., not only to keep families below the poverty level out of the tax system, but also to provide a subsidy. In some respects, this continues its original purpose in that it removes the burden of social security (or even other employment taxes, state and local income taxes, or sales taxes). However, neither the amount of the credit nor the qualifying requirements bear much relationship to these tax burdens. And if the credit is meant to be a negative income tax, these requirements are irrational.

Varying the amount of the credit with family size is rational, since the poverty level fluctuates as well,[68] but the methodology used to determine family size should be the same regardless of marital status.[69] It is not clear why marital status is relevant other than to indicate that, for example, the household may have at least two members rather than one. A single low-income taxpayer may fall below the poverty line due to employment taxes just as easily as a married couple.[70]

I propose to grant an earned income credit to any low-income taxpayer, regardless of marital status, with the credit increasing in size with the number of the taxpayer's dependents.[71] The amount of the credit would need to be restructured so as to award the credit to single taxpayers as well as taxpayers who are married filing separately.[72] The credit would continue to be tied to income levels even though it varied with family size. For example, a single taxpayer might be entitled to a credit of 12% of income; a taxpayer with a dependent might be entitled to 12.5% and one with two dependents might be entitled to 13%. These amounts could be tabularized. Since both the income and the number of dependents could be determined from the face of the return, the Service could ascertain both whether the taxpayer was entitled to a credit and the appropriate amount. The Service could also provide a refund in those cases where the taxpayer failed to take the credit.

The proposal could entail an increased administrative burden from the additional taxpayers who might file a return in order to obtain the credit.[73] This burden could be shifted to the employer through expanded use of the advanced-earned-income-credit,[74] although a return probably would have to be filed in any event.[75] It should be recognized, however, that if the tax system is to be used to provide income subsidies, additional tax returns are an inevitable consequence. Any potential revenue loss could be avoided by taking the current credit expenditure and splitting it among more taxpayers.[76] Alternatively, Congress can take notice that the current system irrationally allocates the "subsidy" in a discriminatory way,[77] and that curing the inequity and complexity will not be free.

The earned-income credit could be simplified even more dramatically if even less fine tuning could be tolerated. The simplest way to benefit low-income families would be to fold the earned-income credit into the exemption by expanding it. This could be accomplished by providing an additional phase-out at a low-income level or by varying the amount of the exemption with the amount of income. Such a proposal appears to be impossible unless only earned income is taken into account.[78] That would be manageable if the taxpayer were entitled to a credit as percentage of wages.[79] The credit could be

based on tables which take into account the number of dependents, much like the current withholding tables. Taxpayers who worked for more than one employer might be required to file a return if their total wages exceeded the ceiling.

Child Care Credit

The Problem. A taxpayer who pays child-care expenses to enable him/her to work[80] is entitled to a credit equal to a percentage of the expenses. As with the other sections already discussed, the taxpayer is required to have a qualifying individual, generally a dependent under the age of 13.[81] This is a workable definition, and as noted above, if other sections were amended, such a rule would provide uniformity for low-income taxpayers. There are two other requirements which do not correspond to the exemption rules (either as currently written or as proposed) which appear to serve little function other than to add complexity. First, the taxpayer claiming the credit must maintain a household which includes a qualifying individual.[82] Second, for an abandoned spouse to claim the credit, s/he must maintain a household for a qualifying individual for more than one-half the taxable year.[83] This definition does not correspond to the usual rule for abandoned spouses.[84]

Proposal. I propose to permit a credit for expenses paid for any qualifying dependent regardless of whether the dependent lives with the taxpayer.[85] Thus an individual would no longer need to meet the "maintaining household" test and the definition of abandoned spouse could be eliminated for purposes of the child-care credit. Although this would simplify the section as well as the corresponding forms, it would not significantly expand the number of taxpayers eligible to claim the credit and thus should not be a revenue loss. How many taxpayers would claim a child-care credit for a dependent with whom they neither reside nor for whom they maintain the household? Two examples come to mind. One is the taxpayer on welfare, whose household expenses are covered by government grants, but who pays her own child care expenses to enable her to work. It seems equitable to extend the credit to the few taxpayers in this category, particularly since it simplifies the provision for all others.[86] The second example is the non custodial spouse who pays for child-care expenses.[87]

More Radical Proposals

Support Allowance

The Problem. Together with the exemption, the standard deduction serves two purposes. First, it defines the taxpaying universe by setting the level of taxable income at which a return must be filed. Second, it exempts from taxation a minimum amount of income, presumably a subsistence level needed for support. Because no evidence of any expenditures is necessary to take advantage of the standard deduction, taxpayers are neither required to keep records nor to understand the various itemized deductions.[88]

If the exemption and the standard deduction serve basically the same function, it is reasonable to inquire as to the need for separate deductions. One possibility is to enable

taxpayers to deduct both exemptions and itemized deductions. Another possibility is that multiple deductions create the illusion of additional benefits. Neither is convincing.

The relationship of the earned-income credit to a support allowance depends on the policy behind the credit. If it is an income subsidy or is used to take the poor off the tax rolls, it can be treated as part of a support allowance. If it is to compensate for social security taxes, that is more difficult.

Proposal. Suppose, however, that each taxpayer was entitled to a single "support allowance" that increased with the number of dependents and varied with marital status. Ignoring itemized deductions and the earned-income credit momentarily for the sake of explication, each taxpayer would deduct from gross income one amount taken from a table.[89] Keeping constant the current amounts of standard deduction and exemptions, the table would look something like the following:

Number of Exemptions[90]

Filing Status	1	2	3	4	5
Married	NA	$9000	$11,000	$13,000	$15,000
HofH	$6400	$8400	$10,400	$12,400	$14,400
Single	$5000	$7000	$9000	$11,000	$13,000
MFS	$4500	$6500	$8500	$10,500	$12,500

The columns could start with zero exemptions, which would have to be provided to cover the taxpayer who is not entitled to a personal exemption because another claims him as a dependent, and for the taxpayer whose separated spouse itemizes deductions.[91] The table could also be adjusted to take into account the additional deductions attributable to age or blindness.[92]

The simplest way to incorporate itemized deductions is to provide that a taxpayer who itemizes takes the greater of the total of his itemized deductions or the amount in the table. At first blush this appears to be quite draconian by, in effect, eliminating the use of the exemptions for a taxpayer who itemizes. But the effect may not be so harsh. First, high-income taxpayers, who almost certainly itemize, already are denied the benefits of an exemption. Second, it is not clear what theory supports an exemption for a taxpayer who itemizes if the itemized deductions are a substitute for a support allowance. However, as the scope of the deductions has narrowed, itemized deductions may in fact no longer be a substitute for a support allowance. If so, the first line on a Schedule A could permit taxpayers to deduct a support allowance of a fixed amount.

Incorporation of the earned income credit is more complex but would overall contribute to simplification. If the earned-income credit is merely an additional subsidy for low-income taxpayers, it can be folded into the support allowance. Thus the amounts shown in the table above could be increased in such a way as to convert the credit into an allowance. Doing so would require extension of the credit amounts to all taxpayers regardless of marital status and an increase in the amount based on the number of dependents. There is one obstacle. The credit is currently linked to income and thus is phased out at upper income levels. There are two possible solutions. One is to have a fixed support allowance for all taxpayers regardless of income level. The other is to phase out the support allowance at certain levels. That is already done for the exemption and the earned-income credit, albeit at radically different income levels. There is no compelling reason, however, why a single support allowance could not be phased out at one rather low income level.

A single support allowance would engender significant simplification. Combined with the broadest of the above proposals and uniform use of the dependency exemption, the brave new world would look like this: Taxpayers would deduct a support allowance from adjusted gross income. The allowance would be based on the number of exemptions and marital status. The head of the household marital status would be eliminated, since there would be no need to distinguish between single taxpayers and head of household, other than rate bracket differential which is not worth the complexity. The earned-income credit would be eliminated. The surviving-spouse status would be simplified so that any unmarried widow(er) whose spouse died in the preceding two years would be eligible. A taxpayer would be unmarried if the spouse did not live with him/her for the last six months of the taxable year.

Limiting the Dependency Exemption to Children

A second radical proposal is to totally restructure the exemption so that it is either taken by the taxpayer or by the taxpayer's parent, but no one else. There are a number of possible alternatives as to how to allocate the exemption. One possibility is to arbitrarily assign it to the parent until the child reaches a given age, for example eighteen. After that point, the child takes the exemption if he files a return, or it is lost. Alternatively, the child and the parents could choose among themselves who is entitled to the election. In the case of divorced or separated parents, the custodial parent would obtain the exemption unless the parents agreed otherwise.[93]

If there is only one exemption per person and only the child or the parent could take the exemption, there would be no need for the gross income test, the joint return test, the relationship test and most importantly the support test. Similarly there would be no role for multiple support agreements.

Taken in conjunction with the proposed support allowance, this rule would substantially simplify the return. For example, the return could ask for the names and social security numbers of any children under the age of 18 (or whatever age is chosen) and the taxpayer's marital status. Armed with that information, the taxpayer would subtract the support allowance (taken from a table) and calculate tax. The Service would also be able

to tell from the face of the return the correct amount of the taxpayer's taxable income and tax.

Two clear advantages flow from these proposals. One is simplification; the other is increased revenue. Who is disadvantaged? Taxpayers who currently support dependents who are not children: mothers, brothers, grandchildren and the like. These taxpayers would have a decreased support allowance.[94] Examination of this proposal provides a good test for how strongly one feels about simplification. Consider this example: If only a child could be a dependent, a taxpayer who supports an elderly mother would be more heavily taxed[95] than a taxpayer who supports a young child. That results in horizontal inequity, since the taxpayer who supports the mother does not have more ability to pay taxes than the taxpayer with the child. The question is how much inequity the system will tolerate in the name of simplification.

An Old Idea--Simplification for the Preparer

Suppose the above proposals were enacted. Would all low-income taxpayers be able to file accurate returns without professional assistance? The answer sadly, but inevitably, is no.[96] Implementing a tax system so simple that almost all taxpayers could comply without assistance would involve enormous tradeoffs that Congress would be unwilling to embrace.[97] First, it appears that we are not yet ready to wholly abandon vertical equity. Thus progressive tax rates and provisions affecting ability to pay, such as the earned income and child care credits, are likely to remain. Second, horizontal equity will assuredly continue to be a hallmark of our tax system which means, for example, that in-kind benefits must be valued and taxed as well as cash wages. Third, Congress shows little appetite for ending the use of the tax system to enforce or encourage compliance with national objectives.[98] Finally, the tax return is often used for purposes unrelated to collection of the income tax, such as the Presidential Election Campaign Fund checkoff and the excess FICA tax refund.[99]

Uniform self-preparation of tax returns is a laudable, but ultimately unachievable, goal.[100] This is a proposition difficult for public officials to accept,[101] and it is not clear that the public, if it understood the issue, would accept.[102] Yet to continue to set this as a goal only exacerbates the problem. While every effort should be made to encourage Congress to enact measures to simplify the tax law, and to encourage the Service to simplify returns,[103] that should not blind us to other avenues of simplification.

One such avenue to explore is taxpayer assistance.[104] Discussion of simplification need not be limited to amendments to the code and regulations. It can also involve limiting the
complexity of compliance.[105] This can be done by assuring that there exists a competent cadre of preparers and practitioners who understand the law, can advise the low-income taxpayer, and can prepare the return for a reasonable fee. The following issues should be explored:

(1) Should tax return preparation assistance be provided by the government or private sector?

How many instances are there where the law is not clear and thus the tax treatment of an item is debatable? In those cases, the Service is likely to take a position favorable to the government; the private sector will favor the taxpayer.

(2) If the government is to provide assistance, can Congress be persuaded to allocate additional funding?

(3) What steps can be taken to improve the quality of telephone and branch office assistance?

(a) Can waiting time be decreased?

(b) Can the accuracy of advice be increased?

(4) What steps can be taken to encourage taxpayers to use government assistance?

(5) If the private sector is the answer, how can this assistance be encouraged?

(a) Is federal subsidy of tax preparation feasible?

(b) Is a federal tax credit feasible?

(c) Is expansion of the VITA or AARP programs an option?

(6) What steps can be taken to improve the quality of private-sector return preparation?

(a) What is the feasibility of better enforcement of current standards?

(b) What is the feasibility of penalties?

(c) What is the feasibility of providing better training?

(7) What steps can be taken to increase the size of the pool of commercial or pro bono preparers?

DOMESTIC-RELATIONS TAX ISSUES

Kiddie Tax

The Problem

As part of the 1986 Tax Reform Act, Congress enacted the so-called kiddie tax to combat income deflection by a parent to a minor child. Apparently convinced that case law

dealing with intrafamily transfers of income-producing property was not sufficient to curb abuse,[106] Congress amended the rate schedules to provide that a child's unearned income is taxed at the parent's top marginal tax rate. The statute applies only to a child who at the end of his taxable year is under the age of fourteen and has one living parent.[107] The child files his own tax return. In most cases he will not be entitled to a personal exemption,[108] and his standard deduction will be limited to the greater of $500 or his earned income.[109] As a practical matter, since most children under the age of fourteen will not have earned income, the usual rule is that the first $500 of unearned income is not subject to tax. The next $500 is not subject to the kiddie tax and thus is generally taxed at the 15% rate.[110]

Current law provides that a parent may elect to include the unearned income attributable solely to interest and dividends on the parent's tax return provided it exceeds $500 and is less than $5000.[111]

While it is possible to argue that any complexity of the kiddie tax should not be of major concern because it applies primarily to wealthy taxpayers[112] who can afford sophisticated tax advice,[113] it seems clear that the rules also impinge on taxpayers who, while not destitute, clearly cannot readily afford such advice.[114]

What are the sources of complexity?[115] They may be broken down into the following categories:

Interaction With the Parent's Return. Because the child's tax rate is computed with reference to the parent's return, a number of problems are associated with this integration such as the graduated rate schedule for trusts, the minimum tax, and the rate-bracket phaseouts. Furthermore, if the parent's return is audited and adjustments are made, the child's return must also be audited and adjusted.

Continued Desire for Income Deflection. It is certainly true that the kiddie tax contributes to overall simplicity in that fewer taxpayers should be involved in the effort to transfer income producing property to minors.[116] Nevertheless, because the rules do not apply to children over age fourteen or to property not producing current income, tax planning continues.

Additional Tax Returns. Children with only unearned income (presumably most of those subject to the kiddie tax) are now forced to file a tax return. Although arguably, in most cases, there should be little opportunity to avoid this obligation due to information reporting,[117] it is not clear whether in fact these returns are being filed.[118]

Proposal

Others have proposed changes which leave the basic structure intact: rate bracket compression[119] and rate bracket assignment.[120] Although worthy of consideration, both proposals offer more, rather than less, complexity.[121] I suggest we explore more fundamental changes. In summary, they would expand the individuals covered and would make the election mandatory.

They are:

(a) Apply the kiddie tax to any dependent child of the taxpayer.

(b) Tax the unearned income of any such dependent on the return of the parent.[122]

(c) Treat the unearned income of any dependent used for his support as funds provided by the parent rather than the child.

These three suggestions are discussed below.

Extending the kiddie tax to all dependent children can be seen on one level merely as extension of my basic notion of uniformity, i.e., to the extent possible, a uniform definition of qualifying individuals should be used.[123] On another level, it can be justified in isolation as simplifying the kiddie tax.[124]

Taxpayers would be far less interested in transferring property to older children (for example, between the ages of fourteen and nineteen) because tax-motivated income deflection would not be possible. Theoretically it is difficult to justify the limited application of the kiddie tax. The problem of income deflection does not end at age thirteen. Why should a fourteen year-old child be able to enjoy a 15% tax bracket on $17,850 of taxable income when a thirteen year-old child is taxed at 28%?[125] Obviously, this cannot be carried to an extreme, since Congress has decided that a single adult taxpayer is entitled to that differential. The obvious place to draw the line is with the natural assignees of deflected income. This would include a child who continues to enjoy the support of the parent and by definition is not earning enough gross income to generate his own high marginal rates.[126]

My second suggestion--to tax the dependent's unearned income on the parent's return--is much more radical, although not novel.[127] Essentially, I would combine the dependent's unearned income with the parent's income in an undifferentiated manner on the parent's return. The dependent would file a tax return only if he had sufficient earned income and if so, that earned income would be subject to his own rates--i.e., he could produce $17,850 of earned income subject to the 15% rate regardless of the amount of unearned income reported on the parent's return.[128] If the child had insufficient earned income, no additional return would be filed. This aspect of the proposal would eliminate the several million kiddie tax returns currently filed.

Such a proposal can be justified on a number of grounds. In the usual case, there is a joint pooling and budgeting of all income in the family unit. Thus the entire economic unit should be considered in judging ability to pay.[129] Even if there is no actual pooling of family resources, aggregation can be justified in that the child's use of his income to meet his own consumption or savings needs relieves the family of that burden and thus increases their power to consume.[130] If the justification for the progressive rate structure[131] is the reduction of economic inequality, the economic power of the family unit is the appropriate measure, since each member's income enhances the family's power to consume.[132]

A corollary of the proposal is that any unearned income used for the child's support must be treated as coming from the parent. A simple example shows why: Assume Parent transfers $250,000 in trust for Child. The trust income of $2500 is used solely for the child's support. The parent spends an additional $1000 for the child's support. Under either current law or the proposed simplification of the dependency exemption, the child would not be the dependent of the parent,[133] and thus the child's unearned income would not be taxed at the parent's rates. Thus the unearned income must be treated as parental support. Since the parent is taxed on the income, this is appropriate.

Issues

A number of divergences from current law and potential problems come to mind and are discussed below:

Differences in the Parent's Tax Base. The current rules provide that any item on the parent's tax return is not affected by the child's unearned income. Since I propose taxing the child's income on the parent's return, I would treat the child's unearned income as the parent's for all purposes. Thus the income would be taken into account, for example, for purposes of computing limits on the charitable contributions deduction, the medical deduction, or miscellaneous itemized deductions.

The child's investment income could be used to offset the parent's investment interest expense.[134] This decision is warranted on policy grounds as well. If the kiddie tax is justified as a means of avoiding income deflection, the assumption must be that the property--and the income produced by it--remains in the control of the parent regardless of documentation indicating otherwise. If so, there is no reason for the parent to treat the income differently from any other. If the income is reported on the child's return and not amalgamated with other income, it is in fact treated dissimilarly.

Property Transferred by Nonparent. The additional complexity and the opportunities for gaming the system are such that we cannot base the tax on the source of the child's income-producing property. Can we justify subjecting the parent to tax on income produced by property transferred to the child from, for example, a grandparent?[135] Currently the tax paid by the child is based on the parent's rate regardless of source, presumably because parents probably enjoy practical control over such property.[136] If this reasoning is accepted, the source of the property is irrelevant. By way of analogy, the income of spouses is currently aggregated, admittedly only with consent, even though neither spouse may have legal control over the income of the other.

More difficult, at least politically, is the income produced by assets purchased with the child's earnings (the interest on the savings account funded from a paper route). While initially a decision to tax the parent on this income may seem harsh and groundless, it acquires appeal on further reflection. This income is also likely to be part of the economic resources over which the parent has control. Even in the case of the twenty-year-old college student who deposits earnings in a bank account, the family unit has made a decision to spend the parent's, rather than the child's, earnings on support.[137] This decision has already been reached under the current kiddie tax rules, apparently without major

revolt.[138] One suspects that we are not dealing with a large number of taxpayers with a significant amount of unearned income from job-related assets.

Divorced or Separated Parents. The issue is which parent must include the income. One possibility to keep the current rule: in the case of divorced or unmarried parents, the custodial parent[139] and in the case of married individuals filing separately, the individual with the greater taxable income.[140] Alternatively, the obligation to report the child's income could follow the dependency exemption, with perhaps a self-ordering exception if the parents desired to allocate it to the parent without the exemption. This should be easy to apply to the proposal since the kiddie tax would expand to cover all dependent children.

Use of Offset. Under current law, the tax at the parent's rate is levied on the unearned income generally offset by $1000.[141] There are two possibilities as to how to deal with the offset if the income is taxed to the parent. One, obviously, is to ignore it. That is, the full amount of the dependent's earned income is taxed to the parent, and the child reports his unearned income decreased by the standard deduction. There seems to be no theoretical reason to exclude the first $1000 of the child's unearned income.[142] It appears that the exclusion was provided for administrative reasons, that is, to avoid many extra returns with small income of unearned income. That reason would not apply if the amounts were reported on the parent's return,[143] since the return would be filed in any event.[144] If one believed that the removal of the $1000 offset is politically unsalable, an alternative is to provide an equal exemption on the parent's return. This could be done by excluding some amount of unearned income for each child.[145] If an exemption is retained, there is one practical problem, but it is no worse than under current law: There would continue to be an incentive for a parent to transfer property producing unearned income to take advantage of the exemption which would not be available if the parent retained the property.

Confidentiality. Practitioners have expressed concern that under current rules, parents may have to reveal their financial status or tax information. However, tenuous an argument this may be, it is virtually eliminated if the income were reported on the parent's return.[146] The reverse problem should not exist: Disclosing the child's income to a parent during a period when the parent is probably legally required to support the child and, in any event, is providing at least half the support, is not unreasonable. The parent already has a legal obligation to prepare and sign a federal income tax return for a minor child.[147] Simplification should also be achieved because there would be far fewer cases in which financial information would need to be transferred. Finally, if the parent must report the income, it is less likely the underlying property will be transferred to a dependent in the first place.[148]

Earned Income. The dependent child would continue to report his earned income on his own return.[149] While a theoretical argument can be made that the entire income of the family unit should be pooled,[150] we do not appear to be ready for such a drastic step.[151] In any event no major complexity appears to result from requiring the dependent to report his own earned income.

Tax Liability. Under current law the tax liability remains the child's; under the proposal it would shift to the parent. This is probably not an important distinction.[152]

Non-taxable Transfers. One corollary of this proposal is that intra-family sales should be treated as non-taxable gifts since the parent will continue to be taxed on the income. That is, no gain or loss would be recognized at the time of the transfer, and the child would take the parent's basis in the transferred asset. If the child sold the asset while he was still a dependent, the gain or loss would be taxed to the parent; if the asset was sold when the child was no longer a dependent, the gain would be taxed to the child. Alternatively, any gain accruing at the time of the transfer could be taxed to the parent upon the child's departure from the family unit. Another approach is to simply ignore the transfers until the child is no longer a dependent--i.e., the parent is still treated as owning the property. At the time the child leaves the unit, "ownership" would pass with the child taking the parent's adjusted basis.

Child Support

The Problem

At the urging of the ABA Tax Section[153] and others, Congress in 1984 extensively modified the provisions of the Internal Revenue Code dealing with alimony, property settlements, and child support. The Tax Reform Act of 1984[154] changed the prior rule that a transfer of appreciated property as part of a property settlement triggered gain to the transferor.[155] Section 1041 now provides that no gain or loss is recognized on an interspousal transfer or a transfer pursuant to a divorce and the transferee takes the transferor's basis. While some criticism has been leveled against this provision,[156] it is generally thought to be a workable improvement which contributed to simplicity in that it made planning significantly easier and more certain.[157] Section 71 was also materially altered so as to make the differentiation of nondeductible property settlements and deductible alimony simpler and less subject to abuse. Under present law, alimony is any cash payment made pursuant to a written divorce or separation agreement so long as there is no liability to make the payment after the death of the payee spouse, and the payee and payor spouses are not members of the same household at the time such payment is made.[158] Alternatively, the couple may "self-order" their affairs by providing in the agreement that the payments are not to be considered alimony.[159] Payments conforming to this federal definition of alimony, regardless of how they are labeled under state law, are includible by the recipient[160] and deductible by the payor.[161] This portion of the 1984 amendments has not been subject to criticism on the grounds of complexity and has been generally supported.[162]

In order to avoid disguising what is essentially a property settlement as deductible alimony, complex rules were adopted providing for recapture of deductions where there is front-loading of alimony payments.[163] While these rules do provide certainty, in that they are mechanical and, if applied correctly, can free a taxpayer from doubt as to the deductibility of the payments, they also are particularly difficult to comprehend. While tax lawyers who on a regular basis handle sophisticated tax planning in divorces where

significant assets are involved have little problem following the intricacies of the recapture rules, general practitioners and tax lawyers who do not do a significant number of divorces apparently find the recapture rules extraordinarily complex.[164]

Unlike alimony, payments for child support are not includible by the recipient nor deductible by the payor.[165] Prior to 1984, payments were presumed to be alimony unless specifically designated as child support in the written agreement under the so-called Lester rule.[166] This proviso produced a significant amount of litigation over whether specific language was precise enough. As part of domestic-relations reform, Congress reversed the Lester rule, treating as child support any amounts specified in an agreement which will be reduced either on the happening of a contingency relating to a child[167] or at a time which can clearly be associated with a contingency relating to a child.[168] Rather than curing complexity, this amendment merely reversed it. One must still use exact language to produce child support, and such a requirement produces a trap for the unsophisticated and unwary.[169]

The continuing differentiation between child support and alimony has created several other problems. While none may be severe by itself, taken together they make advising an unsophisticated and middle-income client on a divorce a difficult process. First, the dependency exemption rules were amended in a salutary way to allow the parents to choose which is entitled to the exemption. In the absence of specification in the agreement, the custodial parent[170] is entitled to the deduction.[171]

Typically, the exemption is awarded to the spouse with the higher income, often the noncustodial parent. Thus, the noncustodial parent often pays for the child's support (through nondeductible support payments) and takes a dependency-exemption deduction. In cases where the custodial parent retains the exemption, problems can arise since it is the other parent making payments for the child. It was for this reason, hat Section 213 was amended to provide that the child is to be considered the dependent of either parent for purposes of deducting medical expenses. Thus, even though the custodial parent takes the dependency exemption, the noncustodial parent can deduct the payments made for the child's medical expenses. However, no such provision was made for either the earned-income credit or the child-care credit. It seems fairly clear that the noncustodial parent will in most cases be unable to take the earned income credit. To be eligible, a taxpayer must be either married with a child for whom the dependency exemption is taken or a head of household which requires that the child live with the parent for half of the year.[172] In order to deduct child care expenses, the payor must be able to take a dependency exemption for the qualifying individual.[173] Thus if the noncustodial parent pays for child care, but has not been awarded the exemption, the child care expenses will not be creditable. If the custodial parent pays for child care, but has released the exemption to the noncustodial parent, the exemption also will be lost.

Proposal

Both the problems with child support and the exemption/credit discongruities can be eliminated if, for federal tax purposes, child support and alimony were no longer differentiated.[174] I propose that any cash payment to a former spouse be treated as alimony

unless the parties agree in writing to the contrary.[174] Thus, what is now labeled as child support would be includible/deductible as alimony. This eliminates the Lester problem altogether by avoiding any need to use specific language to distinguish child support from alimony. It also makes child support clearly subject to self-ordering[176]: the spouses can choose whether to use the deductible/includible or the nondeductible/nontaxable mechanism.[177]

The problems with the credits would also be solved. In most cases, the exemption should follow the taxable child support. That is, if the recipient is paying taxes on the earnings used to support the child, the recipient would ordinarily keep the exemption. S/he would then usually qualify as head of the household (or married) and be able to take the earned-income credit. Similarly, s/he would presumably use the taxable funds to pay for child care, and having kept the exemption, would be entitled to the child-care credit. In the reverse situation, where the parties decide to have the earner pay taxes on the funds used for child support, the custodial parent would ordinarily relinquish the exemption.[178] This solves one problem for the noncustodial parent but not the other--i.e., for both credits, the taxpayer is required to live with the dependent. In the case of divorced parents, this is unwarranted. In the absence of major revision of these credits as suggested above, I would amend sections 32 and section 21 to provide that the parent with the exemption is entitled to the earned-income or child-care credit so long as the child lives with a parent (either custodial or noncustodial). In summary, in keeping with the spirit of the above suggestions with regard to low-income taxpayers[179], the credits would generally follow the exemption and the exemption would generally be allocated to the spouse who pays taxes on the funds used for child support.[180]

Issues

A number of divergences from current law and potential problems come to mind and are discussed below:

Theoretical Justification. The Treasury Department and others have stated that alimony is deductible because the marital relationship has terminated and thus the payment is no longer personal. In contrast, child support is a personal expense and therefore is not deductible.[181] This is wholly implausible. Most tax theorists believe that alimony is deductible as a surrogate for not taxing the earner on funds transferred for the benefit of the recipient spouse who is subject to tax. Thus it is a mechanism to shift the tax and to avoid double taxation of the same funds. If the spouses had remained married, funds used for their support would have been taxed once (usually on a joint return). Although the marital relationship ends, the economic relationship does not, and thus the taxation of the earnings should not change.

If one accepts the theoretical justification for the inclusion and deduction of alimony, it is appropriate to ask whether there is a bona fide reason to treat child support differently.[182] One argument often raised to support nondeductibility of child support payments is that it would give divorced couples an advantage over married couples who are not permitted a deduction.[183] This argument is flawed. The funds used by a married couple to support their children are subject to tax once.[184] The deductible/includible

device[185] permits the same economic result after the marriage ends. The earner/payor would receive a deduction which cancels the tax, but the recipient would pay taxes on the funds. Thus the economic unit continues to pay one tax.

The other objection to self-ordering is that the possibility for tax savings through shifting income to a lower-bracket recipient might create a revenue loss. If the couple remained married and their incomes were combined, the 15% rate advantage would disappear. However, since income shifting is already permitted for alimony, there is not likely to be additional revenue loss: To the extent permitted by state law, taxpayers presumably already use self-ordering to take advantage of the 15% bracket.

On another level, however, one can ask whether it is appropriate to tax the recipient spouse on funds either used for the child or actually transferred to the child.[186] Although this concern has political appeal, it appears that we have long since crossed that bridge. Under current law, earnings used to support dependent children are taxed to the married parents and under either Lester or current law, nonspecific payments are taxed to the recipient divorced spouse. Furthermore, the deduction of child support would not be new. Under either Lester or current law, a divorced parent can deduct payments used to support children by simply failing to label them correctly.[187] The fact that the funds are actually used to support a child is irrelevant.

Practical Changes. Making child support, as well as alimony, deductible, would, in fact, change the tenor of the negotiations between divorcing spouses. No longer would there be a tax incentive for the recipient spouse to request child support as opposed to alimony and the payor spouse to do the reverse. Although, perhaps, ideally tax consequences should play no role in dividing the family wealth and providing for future support, the current system does affect the amount and perhaps the timing of payments. If all payments were subject to one rule, the spouses can decide which spouse should bear the tax on earnings used to support the parents and children.[188] The payment of the tax, in effect, becomes an obligation like any other that must be balanced in the negotiations. Presumably taxpayers will take that into account in much the same way they have accounted for the present treatment of alimony.[189]

Gifts. If child support were to become deductible, one might question whether the payor parent could deduct what would otherwise be a nondeductible gift to the child. This appears to be a concern without substance, however. First, the section limits deductions to cash payments. Thus any in-kind transfer (the bicycle, the radio, etc.) would be outside the rule. Second, the payments must be made pursuant to the decree or written separation agreement. The payor is unlikely to make additional cash payments solely to obtain a tax deduction,[190] and furthermore since the recipient must include the amounts in gross income, s/he is likely to require that they be made pursuant to the agreement. A provision modeled on current law[191] could be included such that any cash payment made by a former spouse is presumed to be pursuant to the decree unless it exceeds the amount specified in the instrument.

MIDDLE INCOME TAXPAYERS--RECORDKEEPING

The Issue

An inquiry into why a middle-income taxpayer who is not operating a business or investing in tax shelters should find the tax law complicated almost always yields the same response: recordkeeping. The refusal of taxpayers to engage in the process of understanding and complying with complex rules affecting simple, everyday transactions is an alarming trend.[192] They do a rudimentary cost-benefit analysis and determine it is not worth the time and the money to comply. Playing the audit lottery, they predict that it is cheaper and more efficient to comply if, and only if, they are part of the 1% of taxpayers who are caught. Tax professionals make similar determinations. Tax return preparation which incorporates detailed recordkeeping and regulations interpretation cannot be priced at a level attractive to consumers. Often, the cost of compliance is higher than the taxes involved. To save time, deductions are estimated, recordkeeping is ignored, or all expenses are presumed to be deductible.[193]

A further examination of the phenomenon finds it rooted in the personal/business distinction. The immense difficulty this poses for the tax system has been well-documented elsewhere.[194] While Congress has made some notable efforts to eliminate controversies caused by the distinction,[195] it has created problems when it was unwilling to declare that specific expenses were presumed to be nondeductible consumption.[196] Recently Congress or Treasury has adopted ever more complicated techniques to distinguish personal from business or investment expenses. Fine-tuning is the order of the day.

It is time to ask whether we have thrown out the baby with bath water. If regulations are complex enough to cover every conceivable transaction, but no one complies with them, what have we accomplished? While it may be argued that, in some cases, the objectionable transactions will simply cease,[197] that is not true with mixed personal/business transactions. It is likely that they continue unabated because, in part, taxpayers will incur the specific expense regardless of the tax consequences. Worse, noncompliance with complex recordkeeping requirements breeds noncompliance in other areas.

The discussion which follows considers a number of problem areas where a radically different approach is warranted. In particular, it focuses on those situations where a middle-income taxpayer would be required to use a professional preparer or, alternatively, would simply ignore the provisions in order to self-prepare. In general, I recommend consideration of either elimination of the deductions, arbitrary amounts for the deductions, or other safe harbors. Obviously, this approach both sacrifices equity and permits noncompliance to shape the system. Both consequences are objectionable. Nevertheless when complexity generates noncompliance, equity must be sacrificed.[198]

Specific Problems

Rental Units

The Problem. Current law permits a taxpayer to deduct the ordinary and necessary expenses of a business or investment activity such as leasing property.[199] Where a taxpayer leases a portion of his residence, he must include the rental receipts in income and is permitted to deduct the associated expenses. Although some expenses, such as repairs, may be allocable solely to the rental unit, most must be allocated between the residence and the rental unit. Records of the expenses as well as the method of allocation must be maintained.

In general, besides the need to keep detailed records, the issues creating the most difficulty for middle-income taxpayers are depreciation and repair versus capitalization. As repairs are immediately deductible as opposed to capital expenditures which are subject to depreciation over time, there is a strong incentive to allocate expenses to the rental unit and preferably treat them as repairs. There is no bright line for homeowners to follow, and taxpayers may be unable to understand or accept the distinction.[200] Depreciation of a rental unit is particularly complex. This is due to three factors, other than the innate complexity of depreciation. One is the need to allocate depreciation--some of the annual depreciation is allocable to personal use and thus is not deductible. The second factor is the rapidly changing law--taxpayers with pre-1981 rental units with recently added fixtures may be using three depreciation systems. The third factor is state law--as discussed below, state law often does not correspond to federal law, and with depreciation, that may mean two entirely separate sets of calculations for a single asset.[201] The use of section 179[202] partially alleviates the first two concerns in that the tension between a deductible and capitalized expense disappears and future changes in the depreciation rules are ignored. However, it often precipitates the application of the passive-loss rules, since the large first-year deduction may create a loss, and it creates a serious problem in states that do not recognize its use.[203]

Possible Solutions. One possibility which would promote simplicity in the case of the rental unit is to permit the taxpayer to deduct an arbitrary amount as a surrogate for the actual expenses. The figure could be a percentage of the rentals, for example 80%,[204] which would eliminate the application of the passive loss rules.[205] In exchange for the fixed deduction, the taxpayer would forgo all deductions attributable to actual expenses--depreciation,[206] repairs, insurance, utilities, etc.--but would not need to maintain any records.[207] Such an option could be elective, so that the taxpayer could deduct the actual expenses (presumably where there was a loss) at a cost of maintaining records and filing a more complicated return.

Another alternative to deal specifically with the repair/capitalization problem is to expand section 179 to cover personalty so that separate depreciation need not be calculated for refrigerators, ranges, boilers, and the like. To prevent a revenue loss, the tradeoff could be an immediate deduction limited to, for example, 80% rather than 100% of basis.[208] The remaining basis could be deducted when the asset is removed from service.

Vacation Homes and Home Offices

The Problem. Similar recordkeeping issues arise in connection with home offices and vacation homes, but there are additional complications. In order to avoid deductions in the case of sham business offices, Congress enacted stringent and complicated limiting rules. The business office must be used exclusively on a regular basis as either the principal place of business for a trade or business, a place of business which is used by patients, clients, or customers meeting with the taxpayer in the normal course of business, or a separate structure.[209] These definitions have given rise to some fairly bizarre case law as taxpayers attempt to push the outer edges.[210] In addition, there is a complex calculation designed to limit the deductions to the income produced by the business.[211]

For purposes of the vacation-home rules, a taxpayer must first determine if he uses the home as a residence: He does if it is used for personal purposes for the greater of 14 or 10% of the number of days it is rented. If so, then all deductions which would otherwise be allowed as business deductions are denied, although the rental income is included.[212] If the unit is not used as a residence,[213] the expenses are deductible. If the unit is rented for less than fifteen days, both the income and the deductions are ignored.[214]

There are a number of possible approaches to simplifying the business-office and vacation-home rules, one quite Draconian, one more favorable to taxpayers. The Draconian solution is to deny any home-office or vacation-home deduction[215] if the taxpayer uses the home as a residence for even a single day. This would eliminate the notch effect for vacation homes.[216] One slightly less stringent possibility is to conform the home-office rules to the vacation-home rules--i.e., if the taxpayer uses the dwelling as a residence for two weeks or more, all home-office deductions are lost. The result should be that in the vast majority of cases, the home-office deduction would disappear. Either suggestion results in some inequity for the taxpayer with a genuine business use for the residence. For example, it would work a potential hardship on doctors, hair dressers, and others whose principal place of business is located at the home. Presumably, they would shift to a rental location. The taxpayer who uses a ski chalet for 15 days and rents it for the remaining 350 days is similarly disadvantaged. The answer for the vacation home is to ignore the income as well since there is not likely to be a significant amount of profit involved. This would not work for the home-office if it is the principal place of business, since most of the taxpayer's income would go untaxed.

Automobile Deductions

Because the personal use of an automobile is not deductible, but business use is, a determination must be made of the percentage of time or miles a car is used for each purpose. The infamous log rules issued by the Service were in response to what the IRS perceived to be abuse in allocations. They were sharply criticized by taxpayers, small business, and accountants as being time-consuming and inefficient with little valuable return.

One way to solve this recordkeeping problem is to eliminate any deduction for automobile expenses in connection with a car used for personal expenses. Although this

would promote simplicity, it is somewhat inequitable in that the costs of genuine business use would not offset income produced by the use of the car. It is also inefficient in that it would encourage taxpayers in such a situation to acquire two automobiles.

Once again the answer may lie in a percentage rule or safe harbor. It would be difficult to use a percentage of income since not all of the income derived from the business may be attributable to the car.[217] Alternatively, one might take a small percentage of annual mileage. For example, assuming the taxpayer can show a business use of the car, he would be entitled to deduct the costs associated with 10% of the annual mileage without producing records.[218] The taxpayer would be permitted to show actual mileage provided he complied with the log rules. Thus, taxpayers could elect out of complicated recordkeeping at the possible cost of the loss of a deduction.[219]

Interest Allocation

Other recordkeeping requirements pale, however, in comparison to the interest allocation rules. When Congress, in the Tax Reform Act of 1986, essentially adopted a basket approach to interest, the need to characterize interest became essential. Whereas the characterization of interest may not be fungible, the funds used to pay interest are, and therein lies the rub. The proposed regulations adopt a tracing approach requiring massive recordkeeping involving almost every expenditure made by a taxpayer. The rules have been subject to unlimited and unceasing criticism, and it is widely believed that both taxpayers and tax professionals are ignoring them.

Issues. It is difficult to discuss the personal interest rules in a vacuum because the combination of the statute and the proposed Treasury regulations relegate all interest (except home mortgage interest) to the basket approach and the tracing rules. Thus the difficulty of proposing any rule for personal interest is that first one must distinguish personal interest from investment or passive interest.

Until this tension is resolved, it seems unlikely that much simplification can be accomplished. But a number of minor changes can be considered:

Minor Changes.

Eliminate the home interest deduction for any residence other than the principal residence. Although some complexity could be eliminated by repeal of any personal-interest deduction, that does not seem likely. There appears to be little justification, however, for the deduction on the second home.[220] In addition to limiting complexity, such an amendment would raise revenue.

Eliminate the deduction for interest on home equity indebtedness. There also appears to be no justification for the retention of this form of personal interest. Since the use of the proceeds is irrelevant, it benefits homeowners who are able to borrow for personal consumption at the expense of those who have no home equity and thus must pay for consumption with current income. Furthermore, present law creates incentives to convert home equity indebtedness into acquisition indebtedness by purchasing a new home.

Assuming acquisition of a home is a transaction Congress wants to use the tax system to encourage, there is no reason to provide a benefit to those who build up equity rather than to those just entering the market or those who pay only interest.

Link the limit on the home-mortgage deduction to interest paid rather than amount of indebtedness.[221] No matter which standard is chosen, inequity results. Under current law, those who live in areas of soaring real estate prices are able to deduct interest on a debt used to acquire a somewhat modest home whereas that amount of debt would support purchase of a mansion in other areas. Conversely, using interest paid as the limit will favor taxpayers able to borrow at low interest rates. Nevertheless, the simplicity gained from the interest paid standard outweighs the inequity. Complex recordkeeping and calculations could be eliminated by using interest paid, a figure readily available to taxpayers.

Consider the use of presumptions. Much simplicity might be gained by making certain assumptions about interest regardless of actual facts. For example, we might presume that any interest expense (other than home acquisition indebtedness) less than or equal to investment income was investment expense. No tracing or security interest need be shown. Thus, that amount of interest would be deductible. Alternatively we could presume that the first $5000 (or any other number) of interest paid by a taxpayer was personal interest and nondeductible. Whether one assumption is preferable to another depends on whether one believes the rule that personal consumption should be taxed takes priority over the rule that there should be no tax when a borrower acquires investment assets because there is no net economic income.

Simplifying the AMT

The Problem. An entirely different sort of recordkeeping problem is created by the alternative minimum tax. Generally, the AMT provisions are designed to take away some of the advantage of certain tax benefits. That is accomplished by adding back to taxable income at least a portion of the tax benefits and imposing a minimum rate of tax. In many cases, that requires taxpayers generally to calculate taxable income twice and specifically to make two calculations for certain transactions.

Proposal. The obvious simplification is to abandon the AMT and attack preferences directly.

State Law

Our federalist system which permits state and local authorities as well as the federal government to impose taxes results in much additional complexity. This complexity takes two forms. First, the failure to coordinate taxes results in duplicative recordkeeping and filing burdens on taxpayers.[222] Taxpayers must essentially file identical information twice or sometimes even three times.

Second, and perhaps more burdensome, is the complexity which results when the state and local law diverges from federal law. For example, taxpayers may be required to keep two sets of books.[223] There may also be conflicting planning goals depending on

whether one followed the state or federal law.[224] Society's mobility, as well as the ability to produce income simultaneously in more than one taxing jurisdiction, gives rise to another set of complex problems. The taxpayer who moves from one state to another or the multistate business can be subject to two taxes on the same income, and complex allocation or credit provisions apply.[225] These problems are not limited to wealthy taxpayers. Low- or average-income taxpayers may also face them. For example, a laborer who works in one state and resides in another is almost always subject to two taxing jurisdictions, as is a taxpayer who moves to a new state during the taxable year.

The obvious answer to the first two issues is piggybacking, which uses the federal tax as the starting point. States, anxious to preserve their sovereignty and power to levy a tax in the manner they choose, have not rushed to piggyback. Thus other approaches on the federal level must be explored. One is to encourage states to adopt provisions identical to federal law.[226] Another is to use federal adjusted gross or taxable income as the initial point for determining state taxes. Neither of these suggestions, however, will solve the problem of state exclusions, deductions, or credits that have no counterpart in federal law. In these situations, the state has decided to provide an incentive either for some state-sited activity or because its public policy position differs from the federal government.

The purpose of this section is not to offer more concrete suggestions. Unless broad federal incentives are provided, simplification will have to occur at the state level. That necessitates a state-by-state evaluation of complexity and proposed simplification tailored to individual state provisions.

The purpose of this concluding section is, however, to issue a cautionary note. The focus of this paper and in fact, the entire conference, is federal tax law. Obviously federal tax law is complex as it is applied to individuals and efforts at simplification should be applauded. For many taxpayers, however, simplification of the federal law and return would provide only limited relief if not accompanied by state simplification. Thus even if we reach consensus on how to repair the Internal Revenue Code, there are many codes left needing attention.

NOTES

[1] Consider the statement by Ronald A. Pearlman, chief of staff, Joint Committee on Taxation, that he believes there is neither a private nor a public constituency for simplification of the tax code, despite the current outcry that tax laws and regulations have become too complicated and burdensome, even for lawyers. BNA Daily Tax Report G-7, 8 (September 26, 1989).

[2] Ironically, their only lobby may be the Internal Revenue Service, which will register a complaint when a provision affecting large numbers of taxpayers is unadministrable.

[3] The former deductions for gasoline and state sales taxes have been repealed and the medical and casualty deductions have been curtailed by the imposition of steep thresholds. This reform was accompanied by a corresponding increase in the standard deduction, which may explain its acceptance. But the elimination of recordkeeping, calculations and the like may have also made the changes palatable.

[4] Even a sacred cow may be slaughtered. The 1986 Tax Reform Act (with subsequent amendments) limited the deduction for the home mortgage deduction, previously thought to be untouchable.

[5] Are the passive-loss regulations, the vacation-home rules, or the earned-income credit limitations analogous to day-old garbage?

[6] Tax professionals have been extraordinarily successful in urging, in the name of simplification, changes in installment sale rules, subchapter S, divorce provisions, and accounting rules. Perhaps tax professionals could unite to work for simplification for the majority in the same manner that we have worked for simplification for the minority.

[7] Other provisions, such as marital status, the kiddie tax, and the domestic relations rules, address the question of who is the proper taxpayer. Any revenue loss would be attributable to rate-bracket arbitrage. The easy, although politically undesirable, way to pick up revenue, when discussing income shifting, is to adjust the rate brackets.

[8] The earned income credit, which is a good example of this, is discussed in notes 61-79 and accompanying text.

[9] The dependency exemption, which is a perfect example of this, is discussed in notes 14-37 and accompanying text.

[10] This paper offers no solutions to the following causes of complexity affecting low income taxpayers: multiple W-2 forms due to second or even third jobs, in-kind fringe benefits, multi-state tax issues affecting interstate commuters, and interaction with welfare benefits. This type of complexity is inevitable. Taxpayers also perceive the tax law to be complex in ways that have nothing to do with the substantive law. They may have had

difficult or unpleasant experiences in handling a deficiency notice, replacing a missing W-2, or obtaining a social security number.

[11] As explained in detail below, it is not possible to eliminate other qualifications since certain benefits, such as the child care credit, are premised on specific expenditures. For example, not every parent with a dependent will have incurred child care expenses.

[12] A single taxpayer is already permitted to file a highly simplified Form 1040E2. Although a significant number of taxpayers using this form also use a preparer, it is unlikely that the concept behind the 1040EZ or the form itself can be made simpler. A taxpayer merely completes name, address, social security number, and wages and takes the standard deduction and taxes from a table. The taxpayer also can request that the Service complete the form.

[13] Because it will be used to determine marital status, which in turn is used to determine the standard deduction and thus the progressivity of the system, it impacts vertical equity as well.

[14] Almost all of the following material is taken from a 1986 report by the American Bar Association Tax Section Task Force on the Dependency Exemption (1986). This task force, which I chaired, proposed a legislative recommendation to simplify the dependency exemption and to provide for a uniform definition of child. Legislative Recommendation 1986-1 was ultimately adopted by the ABA Tax Section on February 1, 1986, and by the ABA House of Delegates on August 9, 1986. See also, Schenk, "Simplifying Dependency Exemptions: A Proposal for Reform," *Tax Law* 35:855 (1982); Thuronyi, Simplification for the Average Taxpayer, *Tax Notes* (July 11, 1988). 186.

[15] This figure is somewhat misleading as an indicator of the number of taxpayers who are exposed to these rules. The dependency exemption is used to determine whether a return must be filed. Thus, many taxpayers not required to file a return must also comprehend the eligibility rules.

[16] I.R.C.§151(c) (1) (A).

[17] I.R.C.§152 (a) (9). A person is not considered a member of the taxpayer's household if the relationship with the taxpayer violates local law.

[18] I.R.C.§152(b) (3).

[19] I.R.C.§151(c) (2).

[20] I.R.C. 152(a).

[21] I.R.C. 152(c).

[22] I.R.C. 151(d) (2).

[23] With the exception of the elimination of the gross-income and the joint-return tests, these proposals are the subject of ABA Tax Section Legislative Recommendation 1986-1, discussed in note 14. Those two tests were not officially recommended because they follow directly from the elimination of the double exemption. The task force making the recommendation believed that issue should be resolved by Congress.

[24] The number chosen prevents possible tax arbitrage due to the elimination of the relationship test, discussed below. Because a taxpayer must contribute at least the amount of the deduction, there is no possibility of using the tax system to profit by providing the minimum amount of support for another.

[25] Most taxpayers would be able to use this fixed-amount objective standard. It is easier to determine than the current "more than one-half of the support" test.

[26] Although this exception adds complexity in terms of verbiage, it makes the exemption much simpler to use. It also assures horizontal equity because, otherwise, there would be some very low-income parents who would lose an exemption if the $1,000 minimum support requirement were imposed. For example, a father with an income of $6000 who provides support of only $800 for each of his four children would have an exemption for each of the children and would not pay taxes on his income. Clearly, such an individual has no ability to pay taxes. Admittedly, the father receives at least a $2000 deduction for an $800 outlay. While the perfect solution is to give the father a deduction equal to the amount paid, the administrative difficulty is not worth the small additional equity. Since the exemption is not refundable, such a taxpayer cannot be said to be arbitraging the system if he receives four exemptions. He is merely removed from the taxpayer universe.

[27] A rule splitting the exemption based on the amount contributed would be the most equitable, but would be completely unworkable.

[28] Residence is defined as living with the taxpayer for more than one-half the taxable year. As discussed below, this is consistent with other residency requirements.

[29] This alternative residency rule is easy for taxpayers to apply and still achieve equitable results. Since housing is the single largest item of support, it is equitable that the taxpayer
providing housing receive the exemption.

[30] This rule is preferable, in these unusual circumstances, to the "more than one-half of the support" rule because it obviates the need for a multiple support agreement if no one provides more than half the support.

[31] If the parents were separated during the first half of the year, I.R.C. § 152(e) applies. That section would have to be amended to conform to the support rules, i.e., tying support to the exemption amount. If the parents separate during the second half of the year, I.R.C. § 152(e) is inapplicable and the rule covering two taxpayers providing the exemption amount applies: the parent who provides the most support gets the exemption.

[32] Note that the alternative provider of support could be the government.

[33] This self-ordering is patterned on the rules of I.R.C. §152(e) for divorced parents.

[34] This is the so-called orphanage problem. An orphanage, which provides a substantial amount of support for the dependent, might sell for $100 its willingness to sign a multiple support agreement in favor of a taxpayer providing little support.

[35] The ABA Tax Section recommendation (see note 14) required one-half of the exemption amount in support, the number which prevented tax arbitrage in the 50% bracket. Setting this number is no longer so simple because of the current rate structure.

[36] Current law requires the person taking the exemption to provide at least 10% of the dependent's total support. Switching to a set figure promotes simplification, although some taxpayers who currently take advantage of a multiple support agreement might no longer be able to do so.

[37] Under current law, a dependent may not have more than the exemption amount in gross income. I.R.C. §151(c)(1)(A).

[38] Even more bizarre, one spouse may be considered married for federal purposes and the purported spouse considered single.

[39] The taxpayer's spouse may not be a member of the household during the last six months of the taxable year. I.R.C. §7703(b)

[40] A taxpayer usually wants to acquire this status because it means that she may use the single or head-of-household filing status rather than the less beneficial married-filing-separately status.

[41] I.R.C. 7703(b)(1).

[42] Id.

[43] I.R.C. §2(b)(1).

[44] I.R.C. §2(b)(2)(A).

[45] I.R.C. §2(b)(3)(B)(ii).

[46] I.R.C. §2(a).

[47] As I discuss below, I believe that two of these provisions could be simplified even further by elimination of the qualifying individual, although I hold out little hope for these suggestions.

[48] Historically, the abandoned spouse provisions originated in the Tax Reform Act of 1969 as the quid quo pro for an additional allowance granted to low-income families below the poverty level. Legislative history indicates that the allowances for a married couple with dependents were less than those for the same number of individuals living separately and thus there was an incentive to separate in order to increase the amount of the additional allowances. See U.S. Congress, House No. 91-413, 91st Cong., 2d Sess. 204-205 (1969). The 1969 Act recognized a family abandoned by a spouse as a separate household for purposes of the additional allowance. Even assuming the requirement had some logic in 1969, it no longer does.

[49] The six-month period is obviously arbitrary and merely tracks current law. Some cutoff is needed, however, to prevent "happily married" taxpayers from filing as singles. Some small complexity would remain in determining whether spouses are actually living apart for the requisite time. However, this is true under current law.

[50] This proposal was also floated at the Conference on Simplification for Low-Income Taxpayers sponsored by the ABA Tax Section in 1981. See also Thuronyi, note 14 at p. 185 which supports a similar rule.

[51] An alternative simplification is to repeal the abandoned-spouse rule effectively requiring a divorce or legal separation. This would, however, create an inequity for low-income taxpayers unable to afford a legal dissolution of the marriage.

[52] Perhaps they are married only in the eyes of the statute. One suspects that many such couples engage in self-help and file as single taxpayers.

[53] Since there is no theoretical justification for current law, the only objection must be loss of revenue.

[54] What other kinds of dependents are possible--mother, a brother, perhaps? The worst -case scenario (from the point of view of political acceptance) would be if the dependent is a friend with whom the taxpayer lives and supports. This example highlights the absurdity of requiring a qualifying individual for abandoned-spouse status.

[55] The only possible argument is that the widow(er) is in more difficult financial straits because of the need to support the dependent child. The weakness of the argument is illustrated by comparing, for example, the wealthy widower with a child or the impoverished elderly widow whose children have left home.

[56] This simplification would make the nomenclature of this filing status somewhat ridiculous.

[57] I.R.C. §2.

[58] I.R.C. §2(b)(3)(B)(i) would be unnecessary, as the proposed definition of dependent would eliminate the relationship test. I.R.C. §2(b)(3)(B)(ii) would also be superfluous, since

any dependents, including those qualifying under a multiple support agreement, would suffice. I.R.C. §2(b)(2)(A) would be unnecessary as well.

[59] I.R.C. §1(b) and (c).

[60] See text accompanying notes 88-92.

[61] I.R.C. §32. The earned-income credit is discussed in detail in Forman, "Expanding the Earned Income Credit to Help the Working Poor," 16 Fla. State L. Rev. 41 (1987). The author proposes a number of changes in the credit which he asserts would transform it into an effective antipoverty program. None of the proposals are aimed specifically at simplification, and several might make it more complex.

[62] I.R.C. §32(c)(1)(A)(i)(1988).

[63] I.R.C. §32(c)(1)(B).

[64] This follows from the definition of surviving spouse, rather than the earned-income rules. I.R.C. §2(a) and §32(c)(1)(A)(ii).

[65] I.R.C. §2(b)(1)(A)(i) and 32(c)(1)(A)(iii).

[66] See Swingen and Long, "Mathematical and Clerical Errors During the 1987 Filing Season," *Tax Notes* (May 9, 1988).

[67] If the taxpayer files a tax return, the error can usually be corrected if the necessary information appears on the face of the return. Currently, information is not complete for all eligible taxpayers, and since the earned income credit is refundable, a taxpayer may not need to otherwise file a return. These taxpayers are outside the system unless they choose to apply for an advanced earned-income credit. However, in 1984, for example, only 10,000 families claimed an advance credit. See U.S. Internal Revenue Service, *Statistics of Income--Individual Income Tax Returns/1984,* 18-35 (Table 1.4).

[68] See Thuronyi, note 14 at 192.

[69] Currently, different tests are used for a married couple and a head of household.

[70] The earned-income credit currently creates a reverse marriage penalty in that the married couple's tax burden increases dramatically upon divorce or separation. If the taxpayers file separately or divorce with only one parent having custody of a child, the credit may disappear.

[71] This is in keeping with my general thesis to use the dependency exemption whenever possible to determine benefits for low-income taxpayers.

[72] These taxpayers are not currently entitled to the credit.

[73] Presumably these would be taxpayers who have too little income to currently file a return, but would file if the eligibility rules for the refundable credit were eased.

[74] Currently an individual who is entitled to the credit may elect to have his employer pay the advanced credit with his wages. I.R.C. §3507.

[75] If the taxpayer receives advanced credit payments, he is required to file a tax return in order to settle his account. I.R.C. 6012(a) (7).

[76] There is also a small potential revenue gain. Some taxpayers currently eligible for the credit would lose at least a portion. For example, a head of household who resides with a child not eligible for the dependency exemption would be entitled to a credit, but it would not increase in size.

[77] Why for example, should a low-income taxpayer living with a grandchild for seven months be entitled to a subsidy, whereas a low-income widow living with her child for seven months should not?

[78] Obviously the earned-income credit would not be limited to low-income taxpayers if a taxpayer with $100,000 of gross wages and $90,000 of tax-shelter deductions were entitled to a credit based on his taxable income of $10,000. Professor Thuronyi proposes, for example, that the credit be based solely on wages and the numbers of dependents. It could be incorporated into the withholding tables and in effect administered by the employer. See Thuronyi, note 14 at 192. As he acknowledges, however, some inequities would result, a price he believes is worth the simplicity. For example, a taxpayer with low wages, but high unearned income, would be entitled to a credit as would a part-time worker whose spouse has high income.

[79] If only wages were used to determine the credit, a taxpayer with low wages and high unearned income would be able to obtain an unwarranted credit. How many taxpayers are there in that situation? Is there a sufficient number to warrant the additional complexity?

[80] This purpose is statutorily carried out by limiting the credit to earned income.

[81] I.R.C. §21(b)(1). Other qualifying individuals are a dependent or spouse who is physically or mentally incapable of caring for him/herself.

[82] I.R.C. §21(a)(1).

[83] I.R.C. §21(e)(4).

[84] See I.R.C. 7703, which is discussed above at text accompanying notes 38-54.

[85] A more radical, and simpler, approach would be to eliminate the child-care credit. This can be justified on the grounds that the credit inappropriately provides a deduction for personal-consumption expenses. If, however, one believes that child care expenses are

business related, then a credit may be supported. This issue is discussed in *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (1985), 19-21.

[86] There are certain to be very few taxpayers covered by this suggestion, because in order to take the child care credit, the parent must be claiming the dependency exemption. Nevertheless, the proposal simplifies the credit for everyone by eliminating a requirement that must be understood.

[87] Id.

[88] Major simplification was achieved in 1986, when Congress raised the level of the standard deduction, thus increasing both the number of taxpayers not required to file a return and the number not itemizing deductions.

[89] This process could be simplified even further by incorporating the support deduction into the tax tables. A taxpayer would look up his gross income in a table, which incorporated the deduction, to determine his taxes. At one time, when the standard deduction was replaced by the zero bracket amount, the Service prepared forms in this manner. They were apparently unsuccessful because taxpayers believed they were being denied the customary deduction. Obviously, education may need to be part of a simplification effort.

[90] Obviously, the table could be extended to include whatever number of exemptions the Service chose.

[91] Assuming the exemption continues to be phased out for high-income taxpayers, that can continue to be done through the tax calculation.

[92] I.R.C. §63(f). The process would be simplified by the elimination of these adjustments. Although the additional deduction attributable to old age has a possible justification, it is much too broad in its current application, since it applies to high-income as well as low-income taxpayers. There appears to be no reason to single out blindness for specialized tax treatment. Nevertheless it is highly unlikely that Congress would ever have the political courage to eliminate these benefits.

[93] This is the current rule.

[94] If the qualifying rules for the abandoned spouse, surviving spouse, and head of household statuses were adopted so that they were not linked to the existence of a dependent, the decreased support allowance would be the only cause for concern.

[95] She would be more heavily taxed because her support allowance would be smaller, since she had no dependent.

[96] See Thuronyi, note 14 at p. 183, which generally appears to disagree.

[97] A simple flat tax on gross wages, such as the social security tax, might accomplish this purpose, but there is no rush to use such a highly regressive tax as a primary source of revenue.

[98] The recent bandwagon to use the tax system to solve national child care problems is a prime example of this.

[99] All of these obstacles are spelled out in detail in Schenk, "Simplification for the Average Taxpayer," *Federal Income Tax Simplification*, ed. Gustafson, (1980), 116-124.

[100] Much of this section of the article is taken from Schenk, note 99.

[101] See *New York Times*, editorial (April 5, 1977), 32: "[A] taxpayer with a high school education ought to be able to do his own return." Two former Commissioners of the IRS have made similar statements: "In our opinion it is wrong that the average American citizen who has a modest wage or salary and doesn't have large deductions to be itemized should have to pay anybody because it is so simple for him to do it himself." (Johnnie M. Walters, quoted in the *New York Times*, [March 18, 1973], 23.) Testifying, Donald Alexander agreed that the effect of simplification was that the average wage earner did not need to employ the services of a preparer. (U.S. Congress, Hearings Before the Subcomm. on Oversight of the House Comm. on Ways and Means, 94th Cong., 1st Sess. [1975]).

[102] While there is a fair amount of evidence that taxpayers wish they could prepare their own returns, there is also evidence that taxpayers are unwilling to exchange benefits for simplicity. While theorists tend to view the question as the degree of complexity we are willing to accept in exchange for increased equity, most taxpayers view the question as the degree of complexity they are willing to accept in exchange for decreased taxes. See Schenk, note 99 at 126.

[103] The Service should also be encouraged to simplify IRS publications, tax-form instructions, and tax-form design.

[104] A significant number of low-income taxpayers already use preparers. A recent study showed that 25% of clients who use tax-preparer services had pre-tax incomes of less than $15,876. Smith, Stalans and Coyne, "A Taxonomy of Paid Preparers for Individual Tax Returns: A Preliminary Analysis of the Tax Practitioner Survey," Paper prepared for the IRS Research Conference on the Role of Tax Practitioners in the Tax System (Washington, D.C., November 1987).

[105] As I have argued before, one is not likely to start down this road unless one accepts two propositions. First, many taxpayers cannot prepare their own returns. Second, this is not a national disgrace. See Schenk, note 99 at 130. Unless one is comfortable with those assertions, one is not apt to devote a significant amount of attention to taxpayer assistance.

[106] See e.g. Helvering v. Horst, 311 U.S. 112 (1940).

[107] I.R.C. §1(i)(2).

[108] I.R.C. §151(f)(2). An individual who is allowable as a dependent to another taxpayer is not permitted a deduction for a personal exemption. This is true even if the parent is not able to use the deduction or if the deduction is denied because the parent's income is greater than the 15% bracket phaseout amount. I.R.C. §1(g).

[109] I.R.C. §63(c)(5). Where the dependency exemption is allowable to another taxpayer, the individual's standard deduction is limited.

[110] I.R.C. §1(i).

[111] I.R.C. §1(i)(7). It is not clear how many taxpayers have taken advantage of this provision which appears to eliminate much complexity. If it has not been used extensively that may be due to ignorance, a disinterest in simplification, or resulting complications on the parent's return. For example, the additional income may effect the 2% floor on miscellaneous deductions, the alternative minimum tax, and various phaseout provisions such as the rental real estate exception to the passive loss rules. The use of the election is also limited by the restriction of income to interest and dividends. Income from a mutual fund or a capital gain would prevent use of the election.

[112] Clearly, some of the complexity is limited to wealthy taxpayers. See Schmolka, "The Kiddie Tax Under the Tax Reform Act of 1986: A Need for Reform While the Ink is Still Wet," *Rev. Tax'n Indiv.* 11 (1987) :99, which discusses complexity due to the interaction of the tax with the trust and alternative minimum tax provisions.

[113] See Thuronyi, The Kiddie Tax: A Reply to Professor Schmolka, Tax L. Rev. 43 (1988) :589 and 598, where the author suggests that one might be more concerned about a provision that imposes a substantial compliance burden on the poor than a provision that involves compliance costs for wealthy taxpayers only.

[114] For example, a dependent child with $500 of earnings and $25 of interest income is required to file a return and pay tax on the $25. This represents approximately a $300 bank account.

[115] Both Professors Schmolka and Thuronyi, the leading commentators on the kiddie tax, agree that the rules are complex. Schmolka, note 112 at 117 ("a solution that...in complexity and difficulty of administration is grossly excessive."); Thuronyi, note 113 at 603 ("The kiddie tax undeniably involves some complexity"). See also Swingen and Long, "A Look Back at the 1988 Filing Season," *Tax Notes* (December 19, 1988) :1343 and 1347, in which the authors report on the results of a survey in which taxpayers reported that the kiddie tax was one of the most significant causes of increased complexity in the 1988 filing season.

[116] It is reasonable to assume that since there is no longer any tax benefit to transferring property producing more than $1000 of annual income, parents are much less likely to make such a transfer to a minor.

[117] One would assume that most of the unearned income is either interest or dividends reported on a Form 1099 and subject to matching by the Service.

[118] See Schmolka, note 112 at 110 n. 25 which suggests that the complexities may result in some taxpayers ignoring the rules.

[119] Professor Schmolka proposes that the rules of I.R.C. §1(e) applicable to trusts and estate apply to the kiddie tax. This is referred to as rate-bracket compression because the amount of income subject to the first level of tax is quite small. Only the first $5000 of income is subject to the 15% rate for trusts as compared to the first $17,850 for a single taxpayer. He argues that this would eliminate much of the complexity. Schmolka, note 112 at 117. See also Baetz, "The Indefensible Kiddie Tax," *Trusts & Estates* (April, 1987) :27.

[120] Professor Thuronyi proposes that a parent be allowed to assign unused rate brackets to children at the parent's election. He gives the following example: A parent filing a joint return for 1988 with taxable income of $51,900 would have an unused rate-bracket amount of $20,000, i.e., the amount remaining to be taxed at a 28% rate before the 33% rate kicks in at $71,900. This unused rate bracket could be assigned to a child, and to the extent of this amount, the child would be taxed at the lower rate. He further proposes that this amount could be allocated among children. Thuronyi, note 113 at 595.

[121] Rate-bracket compression using the current rate for trusts would result in additional complexity in that taxpayers would devise ways to transfer property to children so as to take advantage of the rate-bracket ride. To the extent they do so, we would return to the uncertainties produced by case law, particularly in the murky area where personal service and property income collide. However, as Professor Thuronyi suggests, some of these problems can be avoided with a more severe form of bracket compression, i.e., a *de minimis* amount taxed at the bottom rate. Rate-bracket assignment appears to be quite complex on its face. Furthermore, the possibility that this assignment could be divided among a number of children raises administrative problems.

[122] Professor Schmolka refers to this solution as a "particularly Draconian maneuver," although he does not specify why. Critics will undoubtedly assert that it is obvious.

[123] See text accompanying note 11.

[124] See Schmolka, note 112 at 118; Baetz, note 119 at 29.

[125] This is a tax saving of $2,320 for the fourteen-year old.

[126] According to Professor Thuronyi, this was not the reason age fourteen was chosen. He asserts that the assumption was that children above age fourteen might have substantial earned income, and more complicated financial situations, and might have left home, thus not justifying their inclusion in the family unit. See Thuronyi, note 113 at 599. According to Treasury II, age fourteen was chosen because that is the age at which children may work in certain employment under the Fair Labor Standards Act. See Treasury II at p. 87.

Whatever the reason age fourteen was originally chosen, use of the dependency threshold seems to blunt those arguments. First, if the parent is providing the child's support, it does not seem unwarranted to include him in the family unit. Second, a dependent cannot earn more than $2000 (at current levels) unless he is a full-time student. If he earns $17,850 he is no longer a candidate for income deflection. As discussed below, I would tax the earned income of the full-time student dependent at the student's own rates. That leaves only the question of whether the unearned income of the student dependent is properly within the family unit. I answer this question in the affirmative.

[127] Most tax theorists would determine tax liability based on total family income regardless of the distribution of the income among the family. See e.g. Bittker, "Federal Income Taxation and the Family," *Stan. L. Rev.* (1975) :1389 and 1392, and McMahon, "Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents," *NYU L. Rev.* 56 (1981) :60. A mandatory filing unit of husband, wife, and minor children was proposed in U.S. Dep't of the Treasury, *Blueprints for Basic Tax Reform* (1977), 103-104. See also the following which discuss the issue: H. Groves, *Federal Tax Treatment of the Family* (1963), 70; Bruton, "The Taxation of Family Income," *Yale L.J.* 41 (1932):1172 and 1192; Surrey, "Family Income and Federal Taxation," *Taxes* 24 (1946):980 and 986; Thorson, "An Analysis of the Sources of Continued Controversy Over the Tax Treatment of Family Income," *Natl. Tax J.* 18 (1965):113 and 117-118; R. Goode, *The Individual Income Tax* (1976), 231-234. The kiddie tax is a bow in the direction of taxing the family as a unit. The assumption is that the parent either contributed the income-producing property to the child or exercises control over it.

[128] Taxing the child's earned income at the bottom bracket is possible under current law. It is true that this proposal theoretically offers income shifting in the opposite direction
from the current kiddie tax. That is, if the child is in a higher bracket than the parent due to his own earned income, the unearned income will be shifted towards the parent's lower bracket. However, the universe of such families -- parents in a 15% bracket supporting a child in a 28% bracket -- must be exceedingly small. In any event, there is much less likely to be income shifting in that direction than there currently is.

[129] See U.S. Dep't of Treasury, "The Tax Treatment of Family Income," reprinted in *Hearings on Community Property and Family Partnerships Before the House Comm. on Ways and Means,* 80th Cong., 1st Sess. (1947), 844 and 862.

[130] See, e.g., "Commission to Revise the Tax Structure," *Reforming the Federal Tax Structure* 19 (1973) (a commission sponsored by the Fund for Public Policy Research); 3 Report of the Royal Commission on Taxation 3 (the Canadian Carter Commission). (1966):131.

[131] Which is, after all, the source of this issue.

[132] See *Blueprints,* note 127 at 103; McMahon, note 127 at 86.

[133] The child would not be a dependent because the child would have spent more for her support than the parent did.

[134] I would also attribute any directly connected expenses of the unearned income to the parent.

[135] Originally the Treasury Department recommended that only income from property received from parents be subject to the tax. U.S. Treasury Dep't, *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (1985), 84-85.

[136] See McMahon, note 127 at 90-91.

[137] Remember that aggregation would occur only if the child is a dependent, which requires the parent to be providing support.

[138] The earnings on the child's wages are already subject to the higher rates, although the parent does not assume liability for the taxes.

[139] I.R.C. §1(i)(5)(A). To determine whether the parents are married, the rules of I.R.C. §7703 apply.

[140] I.R.C. §1(i)(5)(B).

[141] Technically the child is taxed at the parent's rates on net unearned income, which is unearned income minus the sum of the current standard deduction amount plus the greater of that amount or directly connected itemized deductions. The current standard deduction for a dependent is $500. I.R.C. §63(c)(5)(A).

[142] Since the child must be a dependent of the parent, it need not be excluded as an amount necessary for support.

[143] As a rule of convenience one could provide that the income need not be accounted for if it is too small to be included on a 1099.

[144] One could conceive of a situation where the parent would not otherwise file a tax return except for the child's earned income, but such a case would be too rare to base any decision on it. In any event, far few extra returns would be filed than under current law.

[145] It is not clear what the number should be. The $1,000 is the amount currently excluded from the kiddie tax; it is not exempt since it will be taxed to the child to the extent it exceeds the standard deduction. Furthermore, the child is permitted to use a standard deduction to offset earned income.

[146] There would continue to be some confidentiality concern in the case of divorced or separated parents. This problem could also be eliminated if the obligation to report the child's income followed the dependency exemption. See text accompanying notes 139-140.

[147] Treas. Reg. §1.6012-1 (a)(4); Rev. Rul. 82-206, 1986-2 C.B. 356.

[148] There still may be, however, estate-planning incentives to transfer the property.

[149] See I.R.C. §73, which provides, "Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child."

[150] See Bittker, note 127; McIntyre and Oldham, "Taxation of the Family in a Comprehensive and Simplified Income Tax, *Harv. L. Rev.* 90 (1977):1573.

[151] This is apparently a more radical idea currently than it once was. Prior to the addition of section 73 (previously section 22[m]) in 1944, a child's earned income was taxable to the parents if they had the right to the income under state law. Income from property was taxable to the minor child. Treas. Reg. 103, section 19.51-3 (1941).

[152] It should be noted also that since the rule would apply only to dependents, matching from 1099s could be accomplished since the child's TIN would be on the face of the parent's return.

[153] See O'Connell, "The Domestic Relations Tax Reform Act: How We Got It and What We Can Do about It," *Fam. L. Q.* (1985):474, which describes the role of the ABA Tax Section and the AICPA in the 1984 reform of the domestic-relations provisions.

[154] P.L. No. 98-369 (1984).

[155] *United States v. Davis*, 370 U.S. 65 (1962).

[156] See, e.g., "Hjorth, Divorce, Taxes, and the 1984 Tax Reform Act: An Inadequate Response to an Old Problem," *U. Wash. L. Rev.* 61 (1986):151, and Lepow, "Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America," *Notre Dame L. Rev.* 62 (1986):32.

[157] See, e.g., Asimov, "An Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income," *Tax L. Rev.* 44 (1989):65.

[158] I.R.C. §71(b)(1).

[159] I.R.C. §71(b)(1)(B).

[160] I.R.C. §71(a).

[161] I.R.C. §215. Alimony is an above-the-line deduction rather than an itemized deduction. I.R.C. §62(a)(10).

[162] See, e.g., Malman, "Unfinished Reform: The Tax Consequences of Divorce," *NYU L. Rev.* 61 (1986):3.

[163] I.R.C. §71(f).

[164] This information was gleaned from conversations with members of the Committee on Domestic Relations Tax Problems of the ABA Tax Section. One could argue that only those competent enough to handle the complexity of Section 71(f) should be advising clients on a divorce. However, the vast majority of taxpayers are unable to afford such sophisticated legal advice on a "simple" divorce, yet the calculation of alimony and the tax consequences flowing from its payment are present in almost every divorce.

[165] I.R.C. §71(c).

[166] *Commissioner v. Lester,* 366 U.S. 299 (1961).

[167] I.R.C. §71(c)(2)(A). Examples include attaining a specified age, marrying, dying, or leaving school.

[168] I.R.C. §71(c)(2)(B).

[169] The temporary regulations attempt to cure the complexity created by this subjective test. They provide that in only two situations will reductions in payments occurring on a contingency be treated as being "clearly associated" with a child. An alimony agreement which uses either situation is presumed to fix child support. In all other cases, support-payment reductions will not be clearly associated with a contingency relating to a child, unless the reductions are expressly related to a payor's child. Temp. Treas. Reg. §1.71-IT, Q and A 18. The two safe harbors are not easy to understand.

[170] The statute technically provides that the exemption goes to the parent "having custody for a greater portion of the calendar year." I.R.C. §152(e)(1) (flush language). This has proven to be something of a problem in jurisdictions permitting joint custody. Obviously, this can be solved by parental agreement as to the deduction.

[171] I.R.C. §152(e). In order to switch the exemption from the custodial parent, that parent must sign a written declaration agreeing that s/he will not claim the exemption for the taxable year. This decision can be made annually or can be a one-time change incorporated into the decree.

[172] I.R.C. §32(c).

[173] I.R.C. §21(b)(1)(A).

[174] It should be borne in mind that the characterization of alimony/child support on the state level does not need to control for federal purposes. There may be compelling reasons why a state would choose to treat alimony and child support differently. As discussed below, there do not appear to be compelling reasons why this should be so for federal tax purposes. Furthermore, this proposal eliminates serious problems when a state court orders unallocated family-support payments. The House of Delegates of the American Bar Association has, at the request of the Section of Family Law, approved a resolution supporting legislation to include family-support payments in gross income and to provide

for a deduction for the payor unless the parties elect otherwise. Support fixed solely as child support would not be family support. See BNA Daily Tax Report G-1 (August 11, 1989).

[175] Specifically I.R.C. §71(c) would be eliminated. The result would be that I.R.C. §71(b) would cover any cash payment received by a spouse pursuant to a written divorce or separation agreement. I.R.C. §71(b)(1)(D) would probably need to be amended in some fashion on the assumption that the payor spouse might be required by state law to continue child-support payments during the child's minority even if the payee spouse was deceased.

[176] Self-ordering is limited to the extent that the provisions of the Child Support Enforcement Act apply.

[177] Obviously, an alternative proposal is for the fall-back rule to be that neither child support nor alimony would be includible or deductible. I have chosen the deductible/includible formulation for two reasons. First, it conforms more closely to current law, and practitioners are accustomed to that approach. Resisting change is itself a form of simplification. Second, a stronger case can be made for taxing the spouse who consumes the income than can be made for taxing it all to the transferor.

[178] The report of the Child Care Credit Task Force of the ABA Tax Section (September 18, 1989) recommended that the child care credit be unlinked from the dependency exemption and apparently recommends that the parent paying for child care be entitled to the credit. As discussed in text, I favor keeping the dependency requirement as part of an overall approach, and also because it would eliminate disputes as to which parent paid for child care.

[179] See Part II.

[180] Of course, under self-ordering, the parents could elect to award the exemption to the spouse not bearing the burden of the taxes.

[181] Letter quoted in *Tax Notes* (February 11, 1985). See also, Moran, "Welcome to the Funhouse: The Incredible Maze of Modern Divorce Taxation," *Harv. J. Leg.* 26 (1989):227 and 134.

[182] Agreement that they should not be treated differently is found in Dodge, *The Logic of Tax* (1989):118.

[183] This was apparently the argument of the Treasury Department during the negotiations over the 1984 Domestic Relations Reform bill. See O'Connell, note 153 at p.488.

[184] The funds are subject to tax by the earner. They are not again taxed when received by the child or the other parent.

[185] It should be noted that electing to make the payments nontaxable and nondeductible accomplishes the same thing. In the interest of simplicity, I will refer to only the former scheme.

[186] One would suppose that if this rule were adopted, most recipient parents who were subject to tax would specify in the decree that the funds be delivered to the recipient or to a specified payee (e.g., a school).

[187] See O'Connell, note 153 at pp. 480-481. The ABA Domestic Relations Task Force supported retaining Lester as the way to reach this result.

[188] The effect of giving a payor a deduction for funds transferred to the recipient is to tax the recipient rather than the payor on the original receipts. Generally, this seems appropriate, since it is the payee who enjoys the benefits of the funds. If, however, the parties desire the payor to pay the taxes, despite the fact that he does not use the receipts, they are free to do so.

[189] Obviously, a transition rule will need to be incorporated due to the many outstanding agreements which were negotiated on the premise that child support was not includible/deductible. The simplest form of transition rule is that which provides that the new rule applies only to agreements executed after the effective date of the amendment.

[190] At a 28% bracket, the payor will have an out-of-pocket cost of 72 cents of each dollar, ignoring the time value of money.

[191] I.R.C. §71(c) (3).

[192] It is a truism that modern economic life is complex, and tax provisions treating the consequences must be complex. One wonders whether the reverse is true: Tax provisions have made relatively noncomplex transactions very complicated.

[193] Numerous professionals involved with tax preparation for accounting firms have expressed these views to me. For obvious reasons, they request anonymity.

[194] See, e.g., Halperin, "Business Deductions for Personal Living Expenses: A Uniform Approach to an Unsolved Problem," *U. Penn. L. Rev.* 122 (1974):859.

[195] See, e.g., I.R.C. §67 which imposes a 2% floor on employee business expenses. While this rule may be validly criticized for creating inequity between taxpayers whose expenses are reimbursed and those whose expenses are not, it vastly simplified the law. The statute effectively presumes that the majority of employee business expenses have a predominantly personal consumption element and therefore should not be deductible. The floor is high enough that most taxpayers no longer keep records. It also should serve to eliminate litigation in the area, although perhaps it will shift to employer-reimbursed expenses.

[196] The most obvious example is the home mortgage interest deduction. Others include expenses in connection with a home office, a vacation home, or an automobile.

[197] This is probably true with the passive loss rules (I.R.C. §469) where tax-shelter activity may have ceased despite the fact that most tax professionals cannot comprehend the regulations interpreting the section.

[198] It is possible that some of the noncompliance is simply a reaction by taxpayers to being stripped of a deduction to which they believed, perhaps erroneously, they were entitled. The business automobile rules probably fall into that category: the objection to the extensive recordkeeping requirements may reflect anger that personal automobile expenses were no longer deductible under the cover of business use.

[199] I.R.C. 162 and 212.

[200] For example, if a taxpayer adds a roof at the cost of $8100 and it is capitalized, he has 27.5 (actually 28) years of recordkeeping which will entitle him to a $300 a year deduction. If he, however, deducts the roof as a repair, he is entitled to an immediate $8100 deduction, and his recordkeeping essentially ends.

[201] New York, e.g., never adopted ACRS. A taxpayer who uses ACRS on the federal return must calculate New York depreciation in a different manner and make several almost incomprehensible adjustments on the state return. If the taxpayer is subject to the AMT, three sets of books may have to be maintained.

[202] Section 179 permits a taxpayer in a trade or business to deduct, in the year of acquisition, the cost of a tangible personal asset which would otherwise be capitalized.

[203] For example, a landlord in New York is not permitted to use section 179 and must depreciate the asset using the state depreciation methods. That results in continuing depreciation deductions (and disparities with the federal return) long after the deduction has been taken on the federal return.

[204] This number should obviously represent a reasonable approximation of expenses, but I do not have data which would permit me to determine that figure. Whatever number is chosen, it should be revenue neutral.

[205] Although technically the rules would still apply, the limitation of the deductions to 80% of the income would prevent a passive loss, the primary focus of the rules.

[206] Some adjustment would need to be made to the taxpayer's basis in the residence.

[207] There is an obvious analogy in the standard deduction.

[208] The number should be whatever percent of basis produces an aggregate deduction equal to the current deduction attributable to depreciation over the recovery period.

[209] I.R.C. §280A(c) (1).

[210] See, for example, *Green v. Commissioner*, 707 F.2d 404 (9th Cir. 1983), where the court reversed a tax court decision which permitted the taxpayer to deduct the cost of a home office used exclusively for telephone calls to clients because the room was not used by clients; and *Drucker v. Commissioner*, 715 F.2d 67 (2d Cir. 1983), where the court, reversing a tax court decision, denied a deduction for a home office for musicians with the Metropolitan Opera, on the grounds that their principal place of business was that of their employer, i.e., Lincoln Center. Congress has also been eager to legislate with regard to other possible evasion devices. See, for example, §I.R.C. 262(b), which provides that the charge for local service for the first telephone line to a taxpayer's residence is a nondeductible personal expense.

[211] I.R.C. §280A(c)(5). There is also a carryover provision.

[212] For example, expenses for repairs, depreciation, fuel, insurance, etc.

[213] For example, the taxpayer rents the unit for 120 days and uses it for personal purposes for two days.

[214] I.R.C. §280(g).

[215] Those deductions otherwise allowable, such as interest and taxes would continue to be deductible.

[216] The notch effect is due to the fourteen-day rule. If a taxpayer, for example, uses the vacation home for thirteen days, all deductions are available. If the home is used for one extra day, no deductions are available.

[217] For example, a taxpayer who uses the car for deliveries may appropriately trace all income to the car. A taxpayer who, however, occasionally uses the car to visit clients may have a significant amount of income unconnected to the use of the car.

[218] For example, if the allowance were 20 cents a mile and the taxpayer drove 20,000 miles in a given year, we would presume 2000 miles were for business and permit a $400 deduction.

[219] Undoubtedly, few taxpayers would benefit if, for example, their actual mileage was only 5% of the total but they were permitted to deduct expenses based on 10%. This distortion seems a small price to pay for simplicity and compliance. Furthermore, it should be offset by the large number of taxpayers who deduct expenses for mileage exceeding actual business use.

[220] Presumably, the provision was included to cover the taxpayer who does not own principal residence (i.e., a renter), but incurs debt to purchase a second residence. The rules are not limited to that situation, however.

[221] See Committee on Tax Structure and Simplification, *Report on the Nonbusiness Interest Expense Deduction,* American Bar Association Tax Section (1989).

[222] Dubin, Graetz, and Wilde, *The Report of the United States to the International Fiscal Association on the Costs of Tax Administration and Compliance* (1989).

[223] This would occur, for example, where state depreciation methods differ from federal methods.

[224] This would occur, for example, where a state failed to adopt a version of Subchapter S.

[225] Allocation problems arise, for example, when a taxpayer lives in one jurisdiction and has investments in another. State law cannot always track federal law. Consider the case of a taxpayer who swaps Blackacre in state A for Whiteacre in state B in a like-kind exchange. He subsequently disposes of Whiteacre in a taxable sale while a resident of state C. See Smith and Hellerstein, "State Taxation of Federally-Deferred Income: The Interstate Dimension," Tax Rev. 44 (1989):5.

[226] For example, in New York, low-income taxpayers are entitled to a real property tax credit; its complexity far exceeds that of any federal credit. Hawaii has several distinct credits which an individual taxpayer might use.

DEATH AND TAXES: ONE IS SIMPLE, ONE IS NOT

BETTY R. JACKSON*

A good tax system should be fair, intelligible, and create the appropriate incentives. The obvious problem is that there is almost always some inherent conflict in trying to meet these objectives. Thus, the task of designing and managing a tax system is characterized by compromise. We are here today because an impressive array of tax talent representing different backgrounds and perspectives argues persuasively that the compromise has failed. The result of this failure is that the tax system is diverting substantial resources away from productive activity and may crumble under the weight of its own complexity. This is not a new cry--the first voices began reaching a crescendo about twenty years ago--but it may be the first time that a critical mass capable of dissecting, analyzing, and putting the problem back together has been assembled.

Professor Schenk has provided an excellent analysis of areas of the tax law in need of revision to achieve reduced complexity for the individual taxpayer. Her recommendations are heavily laced (appropriately) with consideration of factors such as political feasibility and revenue realities. I would like to supplement her paper by making several additions of varying degrees of breadth and political palatability. Many of these suggestions reflect the ideas of several other people discussed in meetings or the AICPA Tax Division's Subcommittee on Simplification, of which I am a member. However, these comments reflect only my opinions and should not be construed in any way to reflect official positions of the AICPA Tax Division's Subcommittee on Simplification or the AICPA.

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PHASE-OUT PROVISIONS

Phase-out provisions have been introduced at a quickening pace in recent tax bills. The intent is to avoid the so-called cliff effect (i.e., the loss of a tax deduction when income goes over the cliff) in the interest of promoting fairness. The intention is noble, but my casual observation of student response leads me to believe that the prevailing view is that these provisions are extremely unfair. When queried about their tendency to continue to view these provisions as unfair despite lengthy discussion about the reasons for the phase-out provisions, senior accounting students at the University of Colorado explain this feeling of unfairness in terms of (1) the fact that taxpayers are given a benefit that is then taken away and (2) that taxpayers with very high levels of income face a lower marginal rate of tax than those with lower levels of income. They understand the purpose and intent of the mechanics of the calculation, but their emotional reaction does not correspond to their intellectual one. It is my contention that if intelligent, relatively financially sophisticated senior accounting students perceive the phase-outs not only to be unduly complicated, but also unfair, the average taxpayer would be even more likely to have that view. If that is true, it is essential that we reexamine the use of phase-outs.

The psychology literature provides some insight as to why these provisions may be viewed as more unfair than alternative structures and suggests that other, much simpler ways of accomplishing the same objectives may be viewed as fairer.

Psychologists Daniel Kahneman and Amos Tversky argue that people perceive outcomes according to the way a situation is framed. They carried out multiple experiments in various contexts to demonstrate the power of framing on the decision process. They have tested this framing effect in various contexts. One example they tested follows:[1]

> Imagine that the U.S. is preparing for the outbreak of an unusual Asian disease, which is expected to kill 600 people. Two alternative programs to combat the disease have been proposed. Assume that the exact scientific estimates of the consequences of the programs are as follows:
>
> > If program A is adopted, 200 people will be saved.
> >
> > If program B is adopted, there is a one-third probability that 600 people will be saved and a two-thirds probability that no people will be saved.
> >
> > > In this scenario, in which the decision was framed in terms of lives gained, 72 percent chose program A. The reference point was that 600 people would die.
> > >
> > > The framing was then reversed to present the options in the alternative of lives lost (i.e., the reference point was a state in which no one dies).

If program C is adopted, 400 people will die.

If program D is adopted, there is a one-third probability that nobody will die and a two-thirds probability that 600 people will die.

Although these two alternatives present exactly the same objective probabilities of life and death as the first set of options, 78 percent chose program D. Even when people are presented with both sets of choices and confronted with their own inconsistency in choice, they tend to prefer their original choices. This example demonstrates the power of the framing effect in decision-making.

This research indicates that gains and losses are interpreted in light of their variation from some reference point. Losses have been shown to be felt more keenly than gains. That is, a decision framed as a loss is viewed as more distasteful than the same decision framed as a gain.

If we examine the framing induced through the structure of the tax law, we can begin to gain intuition as to why the perception of unfairness described earlier may occur. Taxpayers perceive that the tax system imposes no tax on the first $X of income (because of personal and dependency exemptions), a low rate of tax on the next $X of income, and a higher rate of tax on income thereafter. That understanding of how the tax system works establishes their reference point for the calculation of their tax obligations. That is, the tax benefit given on lower levels of income is viewed as an endowment[2] that is bestowed on every taxpayer. The bubble rate of 33 percent, presented as a mechanism to recapture the tax benefits on lower levels of income, is viewed as unfair because of the instinctive reluctance to part with assets framed as a tax endowment.

On the other hand, taxpayers are much more likely to view the imposition of the 33 percent rate as a permanent step up to a higher marginal rate of tax as fair. In this structure (the historical structure of tax rates), all taxpayers are perceived to face the same benefits and detriments under the tax law. No one is viewed as having lost anything; taxpayers simply face a higher tax rate as their ability to pay increases.

Designing an alternative structure to increase perceptions of fairness and decrease complexity for phase-outs of IRA and passive rental loss deductions is a more difficult problem than tax rates, especially when the interactions among provisions are considered. Again, however, we can use our knowledge of framing to recognize that taxpayers subject to the phase-outs frame the law as having given a benefit that it then gradually takes away--often in ways that these taxpayers only vaguely comprehend. They are much more likely to view a system of credits for these benefits as more palatable because the endowment would be viewed as being given only under a limited set of circumstances. Even the presentation of the benefit on the form shows a credit as a direct reduction in tax liability. That is, it will be viewed as a benefit available under certain circumstances, rather than as a benefit given and then taken away.

Designing the system of credits and tables to reflect available credits would be a complex process for the IRS, but application by individual taxpayers could be made relatively simple and straightforward, far more so than the current system.

Phase-outs create incredible planning complexity for tax rates, IRA availability, and use of passive rental losses. The complexity is focused on the middle-income taxpayer who is already burdened with other complexities discussed by Professor Schenk. The clustering of the impact of these provisions creates perhaps even stronger incentives than existed before the Tax Reform Act of 1986 to shift income to other family members or entities, creating additional complexity in the system as taxpayers try to avoid complexity and to minimize a tax burden perceived to be unfair.

The trade-off between complexity and fairness is always difficult to resolve. The phase-out example provides graphic evidence that when that trade-off is being evaluated in the legislative process, much more attention should be paid to the psychological impact of changes in tax structures to ensure that taxpayer perceptions will correspond to the assumptions made by lawmakers.

ALTERNATIVE MINIMUM TAX (AMT) FOR INDIVIDUAL TAXPAYERS

The AMT was instituted when it became apparent that tax preferences were being used to excess, but there was an unwillingness to attack specific preferences directly. Rather, an alternative tax system was devised to calculate taxable income without the benefit of many tax preferences. In recent years, many specific preferences have been attacked frontally (e.g., change to straight-line methods of depreciation) and laterally (e.g., the passive loss rules). The changes should require us to rethink our schizophrenia about what taxable income is or should be.

The spring 1989 Statistics of Income Bulletin presents preliminary 1987 and final 1986 data for AMT on individual tax returns. These data show a dramatic decrease in the numbers of taxpayers affected (114,000 in 1987 versus 609,000 in 1986) and dollars collected ($1.2 B in 1987 compared to $6.7 B in 1986) after the '86 act. One can only guess at what the data will show for 1988 and 1989, but further significant decreases must be anticipated as the TRA 1986 phase-outs are completed. It is obvious that repeal of AMT would cause some revenue loss at the end of that time period, but it would seem to be more rational to analyze the specific preferences that are generating the remaining AMT liabilities and make decisions on the preference accorded each provision than to maintain a dual tax system.

FAMILY/INDIVIDUAL ISSUES

Family Tax Returns

Professor Schenk's suggestion for a family tax return is excellent but may not go far enough. Why not require a family tax return that includes every person for whom a dependency exemption is claimed? The ability to claim a dependency exemption implies a single economic unit. The tax law should reflect this economic reality.

Medical Reimbursement Accounts

The provision under section 150(b) is a classic example of giving the taxpayer a benefit but accompanying it by so many pitfalls and administrative burdens that the taxpayer feels unfairly treated. This benefit could be given so much more efficiently (far less record-keeping and no administrative burden for the employer) and fairly (availability to all taxpayers, not just those whose employers establish medical reimbursement accounts) by simply allowing a deduction of up to a fixed dollar amount for AGI. What possible purpose other than minimization of revenue losses (because taxpayers will be overly conservative) is served by making the contributions nonrefundable? Taxpayers perceive this provision as very complex because of their own record-keeping burden and the difficulty of predicting medical expenses for the coming year with any accuracy.

Power of Attorney Authorization

A procedural simplification would be achieved by placing a box near the signature box that would provide the opportunity to give the preparer or other person power of attorney. This could provide simplification for all taxpayers, but it would be particularly important for individual taxpayers.

BUSINESS RETURNS

Depreciation

Depreciation creates complexity in the system for several reasons. First, the rules change frequently, requiring different sets of records for assets of different types and ages. Second, the flood of different rules for different purposes (e.g. book, tax, state tax, AMT, E&P) requires repetition of this process. Third, each asset must effectively be accounted for separately for purposes of calculating gain and loss.

The most significant proposal for change would be to conform the rules for at least some of these purposes and stem the tide of constant change of rules. Crying uncle on that approach for the short-term, a proposal that would at least make the

record-keeping requirements less onerous is the Open-Ended Account System. In a nutshell, the system establishes an account for each recovery period for personal property. The appropriate percentage is applied to the end-of-year balance and gains, and losses on individual assets are not recognized. Instead, the account is reduced by proceeds received on asset dispositions and increased by asset expenditures (or by half of the expenditure in year 1 if a half-year convention is used). If the account is reduced below zero by disposition proceeds, ordinary income is recognized. When one considers the increased record-keeping requirements faced for purposes of AMT and ACE depreciation, the contribution to reduction of complexity becomes readily apparent.

Mixed-Use Property

Difficulties with allocations in the case of mixed-used properties create unrealistic--and apparently frequently unheeded--record-keeping requirements. Where there are substantial personal and business motives for purchasing mixed-use assets (e.g., autos), the problems of establishing enforceable and reasonable rules are reflected in the difficulty drafters such as Professor Schenk and the AICPA Tax Division's Subcommittee have faced. This area requires a head-on tangle with the trade-offs required between fairness and administrability. I have had no better luck than others with this struggle and can offer no significant improvements at this point.

However, if we bite off a different part of this problem, I think we can develop more administrable guidelines and achieve a tolerable degree of fairness. Some types of mixed-use property don't have the same equality of motive for personal and business use as can be demonstrated for automobiles. For example, it is difficult to demonstrate that substantial value accrues to individuals through the nonbusiness use of personal computers. Therefore, in the case in which significant business use for a personal computer can be demonstrated (e.g., the company's books are computerized and/or the company's business communications are done with the aid of a word-processing program) what has the government lost if the taxpayer uses the word-processing program for personal communication or allows his child to play a game on the PC? The government is in a very weak position in terms of proof in this area. There are more productive areas for battle than this one.

In contrast, photographic equipment has significant personal value relative to its business value in most cases. That is, the equipment is integral to the business of a professional photographer, but only an enhancement to a real-estate agent or plastic surgeon's business. The equipment itself should be considered personal use equipment in those cases, and only direct costs (i.e., the cost of film) plus a relatively low flat amount at the point of purchase (e.g., $200) would be deductible in cases in which the equipment is not integral to the taxpayer's business.

To state this as a general rule, where the property is essential or integral to the taxpayer's business and there is no equivalently strong personal use motive (as there would always be assumed to be for a car), the property should be treated as 100 percent business property. Where the opposite is the case, the property should be treated as 100

percent personal-use property with no deductions allowed except to the extent incremental costs are incurred. In the case in which the taxpayer would have approximately similarly strong motivations to purchase the property for both business and pleasure (as we assume for a car), we must face the task of improving the administrability of allocations of the related expenses.

CONCLUDING COMMENTS

In my comments, I have made several micro-level suggestions as to various aspects of the law that could be made more comprehensible. I have also addressed some structural characteristics of the law that merit thought. What I have not discussed is what I consider to be the single most important contributor to tax complexity: the process. It is imperative that we take an initiative to hammer home the point that the law making process that has evolved dooms us to a tax law that looks like a Christmas tree decorated by children. Some individual pieces are beautifully crafted and hung with great care. Others are not as pretty but are there because they were the best anyone could come up with and a spot needed filling. The most striking thing is that when we step back and view the whole tree, it is not a pleasing sight. We can almost visualize the battles that took place in establishing each child's turf.

The Tax Reform Act of 1986 accomplished a major task in rectifying many of the structural problems of the law and integrating the individual parts. These changes (e.g., capital gains, corporate rate structure versus individual rate structure, the flat rate structure) have had significant influence on reducing structural complexity. However, reliance on this sort of a correction is somewhat like waiting for a periodic earthquake to adjust for stresses building up on various fronts over long periods of time. Such major upheaval may correct the immediate problem, but it causes disruption in unpredictable ways. We must find a way of rationalizing the process by which the tax law is made if we are ever to solve the problem of excessive complexity that has brought us together for this conference.

ENDNOTES

[1]Kahneman, Daniel, and Amos Tversky, "Choices, Values, and Frames," American Psychologist 39 (April 1984), 341-350.

[2] Thaler, R., "Toward a Positive Theory of Consumer Choice," J. of Economic Behavior and Organization (1980), pp. 39-60.

COMMENT ON "ELIMINATING COMPLEXITY FOR INDIVIDUAL TAXPAYERS: A REVENUE LOSER WITHOUT A CONSTITUENCY?"

STEVEN D. KITTRELL*

Not having the benefit of being an academic, my comments are not principally addressing the specific discussion that I hope will take place on the proposals that Debby Schenk has put forward. I would like to make a couple of comments on the process of individual tax reform and then suggest aspects of the specific proposals that I think are important.

The first comment relates to Debby's title, which implies there is a lack of a constituency for individual taxpayer reforms. I think if you look at the history of tax reform in the last seven or eight years, you will find that the AICPA and the ABA have been the only even moderately effective voice for simplification in the areas of individual tax reform, and that includes the Domestic Relations Tax Reform Act and some other projects.

But one thing that shouldn't be overlooked when we are talking about the lack of a constituency is that we also don't have, as Ken Gideon put it at lunch, a "gored ox out there bellowing." If we can get the attention of the policymakers in the Treasury and the legislative process, there will not be a great dissenting voice to what we would propose.

Now I want to put that observation in the context of one of the reform processes that I was involved with, the domestic relations tax reform project. That project started as a joint effort of the two organizations sponsoring this conference. We spent a number of years, and untold hundreds of hours, putting together what we thought was a theoretically correct and practical way of handling all aspects of domestic relations taxation. Once that was done, it took about two years to get the attention of the people in Congress to get the proposal into the legislative pipeline, and that is when the problem started.

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At every step of the process--starting with Ways and Means Committee hearings, the Ways and Means markup, then over to the Senate side, all the way through conference--you could see that the size and complexity of the proposal was increased each time there was further consideration. It was simply a matter of trying to solve every conceivable abuse or every conceivable unfair situation with a more technical and more specific rule. Regardless of what you might think about the ability of IBM or some other companies to handle those kinds of complexities, it is clearly not reasonable to expect either the normal divorcing individual or their divorce lawyer to understand these technical rules or to be able to apply them correctly.

The result has been that what could have been a substantial reform has only been a minor reform, and a lot of work is left to be done. I should mention that the process of trying to solve every problem with a more technical rule was not a government representative's problem only; it was shared equally by those of us from the private sector who felt that a particular proposal was going to be unfair to a certain segment of our clients.

Just as an example, take the alimony recapture rules. The idea is that you want to prevent front-loaded alimony payments. The classic example is that it is wrong for an individual who is getting divorced to pay a $1 million to his wife on the date of the divorce and deduct that payment. However, it is okay if he wants to pay $330,000 for the first three years and deduct those payments, but it is wrong to do it the first year.

Now ask yourself, why is a single payment wrong? The only theoretical justification that was ever put forward was that it was a disguised property settlement and that, by spreading it out, you got rid of the disguised property settlement. And we had hours of debate about what is or is not a property settlement.

The point I am trying to make is that once the process got off on the track of needing some way to prevent disguised property settlements, there was never an opportunity in the process for discussion about why that is a bad thing to have happen.

So the theories that Debby has put forward in her article about a conceptual framework for addressing these individual tax issues are as important as the work that goes into something like the subchapter C reform project. You need to have a theoretical underpinning, and if that underpinning is that we are going to accept some gaming by taxpayers and some unfairness in certain situations, then I think you could come out with a workable set of rules. Otherwise, you are going to end up with inevitably complex laws.

The idea that I would like to put forward to help toward that concept of a theoretical model for dealing with these individual tax issues is this: Wherever possible, the expectations of individual taxpayers ought to be followed as to what the right results should be. An example that illustrates the point is the deductibility and includability of alimony.

If you go up to almost any person on the street and you say, "You are going to pay your wife alimony. Should it be deductible and should she have to pay tax on it?" the answer is going to be "Yes."

It is just as theoretically reasonable to have the general rule be that alimony should be nondeductible and nonincludable. From a tax policy and economic basis, you can simply adjust the amounts that are being paid and get to the same net economic result, but the point is that taxpayers are more likely to follow the system if you have a rule that fits in with their expectations of what ought to be the result.

That concept follows through into other areas. For example, the "kiddie tax." Debby's proposal is basically, as she said, to make the aggregation of the child's income on the parents' return mandatory. That to me is more reasonable and more the expectation of the parent-child relationship than to have a child filing a separate return on individual income. Therefore, I think it would make a lot of sense to adopt that kind of a mandatory rule.

The analysis would support the proposal that Debby has made with respect to the dependency exemption. Basically, her proposal operates on simplifying the support tests. It sets up a screening process where you try to catch as many taxpayers as you can within the first level of the screen, which is if an individual provides more than half of the support for a person (or if there is no other person providing support), then you don't care how much support was provided. For example, there would be a presumption that the parent is entitled to the dependency exemption if no other person provides support greater than the exemption amount. If two or more people provide that basic amount of support, her test would be that whomever the dependent resides with would be the one who takes the dependency exemption. Again, that would correspond with the expectation of your normal taxpayer.

In a situation where two or more people provide that basic amount of support, and neither or both live with the child, only then do you go to what is now the current-law test of who provided the most support. By screening at the different levels, not only is it simpler for the vast majority of people but you also have met the reasonable expectations of those individuals.

The final point I'd like to make relates to the proposals about child support. The morass of current child support tax rules is a direct effect of the efforts to eliminate any perceived bad tax results. The ABA-AICPA proposal that originally was put forward in this area dealt with including child support in the private ordering system. Individuals who are divorcing would have made the first level of the determination of who is going to be taxed on payments that pass between former husband and former wife. If the parties can agree or if a court can make an order about who ought to be taxed, private ordering would be the simplest rule. Child support would have been treated just like any other cash payment in that analysis. The perceptions of the potential for abuse were such that the simple approach didn't happen. There are very complicated rules for determining which pieces of payments are child support and which are not.

The resolution of this kind of dilemma should not be increasingly technical solutions. There should be some forms of objective criteria that can be used to determine the tax result. For example, the Child Support Enforcement Act that has been enacted at the federal level compels every state to have child support guidelines in place. Those guidelines

must be used in virtually every court order. Certainly, every court order involving our "level 1" and "level 2" taxpayers is going to have a number that says this amount is child support. While I normally don't like relying on state law for resolving tax issues, it would certainly be a simple system to provide that if the judge has said that a payment is child support, then the payment is child support for the federal tax system. I think people would expect that result. That is not always the case under the current rules.

I'll sum up by saying that I think Debby's proposals are certainly a good point to start from, but unless this group and those of us who are interested in it are willing to spend the effort, nothing is ever going to happen in the area of individual taxpayers.

AT-RISK AND PASSIVE ACTIVITY LIMITATIONS: SHOULD COMPLEXITY BE REDUCED?

STANLEY A. KOPPELMAN*

The at-risk limitations of Code section 465 and the passive activity loss limitations of section 469 are directed at the perceived problems of tax shelters. Both provisions are detailed and complex. The at-risk rules, first enacted in 1976, have been amended on several occasions.[1] The present rules represent the evolution of a detailed statute and regulations, complemented by numerous revenue rulings and court decisions. The passive activity loss ("PAL") limitations, enacted in 1986, are now accompanied by two lengthy sets of regulations dealing with most of the major interpretive issues raised by the statute.[2] It should come as no surprise that these rules have been criticized for their complexity.[3] The PAL limitations have contributed significantly to the elimination of tax shelters and the complexities that tax shelters created. Yet the complexities of the PAL limitations themselves invite consideration of simpler (and fairer) alternative ways to eliminate tax shelters.

In this paper, I will first discuss the general question of simplification. Because there is no generally accepted definition of complexity with regard to taxation,[4] it is important to clarify what the terms "complexity" and "simplification' entail. I will indicate why it is important to consider planning or transactional complexity as well as compliance complexity in evaluating the complexity of tax rules.

I will then turn to the specific problem of tax shelters. I will indicate why the PAL rules, when transactional complexity is considered, have actually simplified the tax laws by effectively eliminating tax shelters. Nevertheless, because the PAL rules themselves are conceptually flawed and highly complex, I will consider alternative methods for dealing with the tax shelter problem. After considering these alternatives, I will address possible changes that could be made to the passive activity loss rules assuming these rules continue to be the method of dealing with tax shelters.

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COMPLEXITY OF THE TAX LAWS: IN GENERAL

Existing Literature

The existing literature on the complexity of the tax laws is instructive for what it does and does not discuss. Significant attention is paid to the causes of complexity.[5] Attention is also paid to the consequences of complexity.[6] Criticism is sometimes also directed at the promulgation of lengthy regulations[7] and the various components of the political process that have produced our complex tax system.

Of greater significance are the topics which are all too infrequently addressed. Discussions of complexity rarely attempt to define what complexity means.[8] The implication is that we all know a simple rule when we see it, so there is no need to map out what precisely Congress ought to do or how Treasury regulations ought to be written. Also implicit in these discussions is the idea that shorter rules are better than lengthy ones and rules with fewer categories are better than requiring the analysis of many factors.[9] Although criticism is often directed at the political process, concrete recommendations for simplification are rarely provided to legislators wishing to achieve a less complex system.[10] It is thus far from obvious how to define and evaluate the complexity of the tax system or how to reduce or eliminate complexity which has been identified.

The literature on tax simplification often suggests that significant simplification could be achieved if only more attention were paid to the problem. While this may be true with regard to certain tax expenditures, this analysis of simplicity is itself far too simple. It is not obvious what contours a "simplified" income tax should take.[11] It may just be that any respectable version of an income tax is not very simple.[12] Put another way, simplicity is not the only relevant value in designing tax rules.[13] A complex rule often is the result of the failure to accept a simpler rule which is considered less fair or efficient.[14] It may well be difficult to achieve the goals of an income tax without a certain amount of complexity.

Types of Complexity

Complexity has both a compliance and a planning component. Tax rules are complex to the extent that they make compliance with these rules difficult.[15] From the taxpayer's perspective (or from the perspective of the taxpayer's tax return preparer), rules are complex to the extent they make difficult the accurate completion of tax returns or other required forms. Included in compliance complexity are rules requiring the maintenance of logs or other contemporaneous taxpayer records in order to justify a deduction or other tax benefit. From the Government's perspective, rules contribute to compliance complexity to the extent they make difficult the job of enforcing the tax law.

Planning complexity refers to the costs associated with structuring transactions to achieve favorable tax results and evaluating the tax consequences of potential transactions. Thus, rules which result in differential tax rates for difficult types of investment income contribute to planning complexity by increasing the need to carefully examine tax

consequences in evaluating investment options.[16] Especially with regard to high income taxpayers, planning complexity, sometimes referred to as transactional complexity,[17] is potentially of far greater significance than compliance complexity. It is one this to face the inconvenience (usually through higher return preparation fees) of return preparation; it is quite another to have to factor tax consequences into business and investment decisions on a continuing basis in order to make informed decisions.

The complexity resulting from lengthy and complicated rules has been identified as a separate type of complexity.[18] Although this categorization is analytically helpful, it should be noted that there is nothing inherently complex about a lengthy or complicated rule apart from its effect upon structuring transactions or complying with the tax laws. Indeed, the focus upon the complexity of rules other than in the context of planning or compliance tends to obfuscate the identification of what it means for a rule to be complex.

The error of focusing upon the length of a rule as a test of its complexity is a natural one for lawyers and accountants to make, When the elimination of preferential rates for capital gains was proposed as part of the package that ultimately became the Tax Reform Act of 1986, I confess that my first reaction was to evaluate the simplification gains of this proposal in terms of the number of Code provisions slated for elimination. But the real measure of simplification is the extent to which the planning and compliance burdens of preferential rates were reduced. Although the elimination of preferential rates did indeed make the tax law simpler, it was not because a number of Code provisions were eliminated.[19] One can imagine tax provisions the repeal of which actually complicates the tax laws. For example, the repeal of the capital loss limitations could result in a more complex tax system. Although rule complexity would be reduced, transactional complexity might be increased as taxpayers and their advisers plan ways to offset ordinary income with capital losses. As I will discuss later, the repeal of the passive activity loss rules could have this complicating effect.

Optimal Rule Precision

Before examining the question of complexity in the context of certain anti-tax shelter rules, it may be helpful to approach the question of rule more generically. Wit regard to any legislative or regulatory problem, the question arises as to the optimal degree of precision any rule should have. It may be helpful first to address the question of precision outside the context of taxation.

Consider, for example, the question of regulating airline pilots.[20] A policymaker charged with the responsibility of developing certification criteria for commercial aircraft pilots may be faced with the job of specifying the circumstances under which a certified pilot should be required to retire. Suppose that the general policy objective is to have pilots retire when the social cost of allowing them to continue, as determined by the risk of accidents and their consequences, exceeds the social benefit, represented by the costs avoided by not having to find and train a replacement.[21]

Three possible formulations of certification criteria are:

1. No person may pilot a commercial airplane after his sixtieth birthday.
2. No person may pilot a commercial airplane if he poses an unreasonable risk to an accident.
3. No person may pilot a commercial airplane if he falls within one of the following categories. (There follow tables displaying all combinations of valued for numerous variables, including years and level of experience, hours of air time logged, age, height, weight, blood pressure, heart rate, eyesight, and other vital signs, that would disqualify a pilot from further eligibility to pilot aircraft.)[22]

A number of observations regarding complexity are suggested by this example. First, Rule 1 is the simplest rule in several respects. It is "transparent" in that its meaning is clear. Few interpretive problems arise in defining what is meant by age 60.[23] Rule 1 is also "accessible" in that it can be applied to specific fact patterns without difficulty.

Rule 1 is not, however, without its problems. Transparency and accessibility each has its price. Rule 1 is undoubtedly arbitrary in the way it determines which pilots must retire. Under this rule, some pilots who do not in fact present a significant risk of accident are forced to retire while other pilots who may suffer from age-related problems affecting their fitness to fly are allowed to maintain their license. In this regard, Rule 1 may not be "congruent" with the policy sought to be achieved by the rule.[24] The tax literature sometimes describes this situation as a tradeoff between simplicity on the one hand and equity and efficiency on the other.

Rule 2 and 3 illustrate that the complexity of a provision is not necessarily determined by its length. Although Rule 2 is much shorter than Rule 3, it is not necessarily simpler (either in the sense of transparency or accessibility). The definition of "reasonable" may ultimately incorporate the kinds of variables explicitly contained in Rule 3. Under this circumstance, Rule 3's explicitness is an advantage; it is more transparent that Rule 2.

The focus upon optimal precision thus introduces several useful concepts. First, what is generally referred to in the tax literature as simplicity can be broken down into the distinct components of transparency and accessibility. Although lengthy rules may in some cases be less accessible than shorter rules (Rule 1 is more accessible than Rule 3 although Rule 2 is not necessarily more accessible than the longer rule 3), They may yield concrete answers more readily than opaque standards such as "unreasonable risk."

Tax rules and regulations tend to be some combination of Rules 2 and 3. Tax rules often attempt to provide objective standards providing answers to many common fact patters. A more amorphous "facts and circumstances" test is often reserved for other cases. This basic approach, although not necessarily its execution, is reasonable. The definition of the "material participation" standard in the PAL regulations is one example of this approach. These Regulations provide six objective tests for determining whether a taxpayer materially participates in an activity.[25] The Regulations also provide a seventh "facts and circumstances" test.[26]

Second, simplicity is but one value to be considered. Achieving simplicity often requires substantial concessions regarding other values such as equity and efficiency. The arbitrariness of Rule 1 may be neither equitable nor efficient.

TAX SHELTERS

Both PALs and at-risk rules are responses to the phenomenon of tax shelters. A tax shelter is an investment in which a significant portion of the investor's return consists of tax benefits that not only offset any tax liability that might otherwise arise from the investment but also "shelter" other income of investor, usually from the investor's business or professional activities. The components of the tax shelter - deferral, leverage, and the (pre-1986) conversion of ordinary income into capital gains - and how they work have been well documented.[27]

Tax shelters may be divided into two categories: "regular" tax shelters and "abusive" tax shelters and "abusive" tax shelters. Regular tax shelters are comprised mainly of legal tax benefits; abusive shelters involve the sheltering of unrelated income through tax benefits beyond those intended by law and generally have little or no economic reality.[28] This distinction is relevant for contrasting the purposes of PALs and the at-risk rules. The at-risk rules were largely a response to abusive tax shelters involving the overvaluation of depreciable property through nonrecourse debt. PALs, on the other hand, were created to defeat the sheltering of virtually all tax shelters, whether regular or abusive.

While abusive shelters are universally condemned, there is no consensus or whether regular shelters should be eliminated. Regular shelters involve the combination of deferral achieved through the use of tax provisions that do not accurately measure economic income and leverage which generates deductible interest. This combination is generally referred to as "tax arbitrage."[29]

Some believe that tax shelters represent a threat to the integrity of our tax system. Tax shelters are asserted to be both inefficient in that they cause a misallocation of resources and inequitable because tax shelter benefits are derived mostly by high-income taxpayers.[30] Their perception as inequitable has the potential of reducing compliance by those not able to invest in tax shelters.[31]

Others maintain that as long as the deferral is accomplished through provisions which Congress explicitly intended as a subsidy, there is no reason to place limitations on shelter portion of the transaction.[32] The notion that tax shelters are a windfall for the rich is said to be illusory as long as the tax benefits are capitalized in the price of the shelter.[33] Moreover, any inefficiencies arising from misallocations of resources are defended on the grounds that Congress specifically determined that the tax-favored activity should be subsidized.

Whatever the merits of the equity and efficiency analyses, tax shelters have been a major contributor to the complexity of the tax system. Planning or transactional complexity involving tax shelters prior to the advent of PALs was enormous.[34] Tax shelters usually involved a complex structure designed to minimize the tax benefits offered to investors. A substantial industry arose to structure and market tax shelters. Compliance complexity was also tremendous for both taxpayers and the Internal Revenue Service alike.

APPROACHES TO TAX SHELTERS

Current Law

Current law incorporates a variety of approaches to tax shelters. Various penalty provisions are designed to deter the promotion of and investment in abusive tax shelters. Audit mechanisms (such as for the audits of certain partnerships) have been implemented in order to streamline the audit process.

Of the substantive provisions directed at tax shelters, the at-risk rules and PALs are the most prominent. The at-risk rules limit the deductibility of losses from an activity to the amount the taxpayer has at risk with respect to that activity. Tax losses deemed financed by nonrecourse indebtedness are thus deductible only against income from that activity. Although initially applicable only to a handful of activities, the at-risk rules are now broad in scope and apply to most activities.

PALs represent the broadest attack ever launched against tax shelters. They have virtually shut down the tax shelter activity in this country. Under these rules, losses from passive activities may only be used to offset income from passive activities. The possibility of generating tax losses from a passive activity to shelter trade or business or professional income is foreclosed inmost cases.[35] Limited exceptions apply to losses from rental real estate,[36] working interests in oil and gas properties,[37] and low-income housing.[38]

The at-risk and PAL rules are not the only substantive provisions directed at tax shelters. Provisions such as the alternative minimum tax[39] and the investment interest limitations[40] are also aimed at limiting the ability of taxpayers to shelter income.

The 1986 Act: Reduced Complexity

Criticizing the current anti-tax shelter rules for their complexity has become standard fare.[41] While much of this criticism is well-founded, it should be placed in proper context. Notwithstanding the length and detail of PALs, they represent, in my opinion, a net simplification of the tax system. The success of these rules in eliminating complex tax shelter investments has simplified the investment decisions for most high-income taxpayers. Although the rules themselves are unquestionably complex, this complexity does not affect, other than transitionally, many investors who have curtailed investing in tax shelters. As old tax shelters are disposed of, the rules will apply to an increasingly small number of

taxpayers. To be sure, some taxpayers will face increased complexity as a result of these rules. Nevertheless, I suspect that the increased complexity for those taxpayers who will contend with the PAl requirements is more than offset by the reduced complexity to the substantially larger number of taxpayers who will benefit from simplified investment decisions as a result of these rules.

This is not to say that the current rules are the best we can do. Various alternatives are discussed in the remainder of this paper. But it does indicate that curtailing tax shelters represents a major move in the direction of simplification and that any change not result in the resurgence of the tax shelter industry.

Alternative Approaches - "Pure" Tax Bases

Broaden the Income Tax Base

One alternative is to eliminate the provisions giving rise to the deferral and the consequent tax arbitrage directly rather putting a lid on the tax benefits only in certain cases. The broadening of the tax base would be accompanied by the repeal of section 469. I endorse these proposals. That tax preferences are acceptable to shelter income from passive activities but not from portfolio investments or human capital is difficult to justify as a matter of pure theory.[43]

If Congress were willing to adopt such an approach, it is likely that tax shelters would remain suppresses without limitations on passive activity losses. Even though all deviations from the measurement of economic income would not be eliminated,[44] the reduction in marginal rates accomplished by the 1986 Act has substantially reduced the value of tax losses. Further base broadening would also make it easier for Congress to prevent increasing marginal rates. Base broadening would thus contribute to preventing the return of shelters in the absence of specific limitations in two distinct ways.[45]

Consumption Taxation

Some have suggested that the best way to reduce complexity is to adopt a consumption-type personal income tax.[48] A cash-flow consumption tax is asserted to remove many of the complex issues raised by an income tax or a hybrid tax system. The lack of experience with a consumption tax makes it difficult to predict whether there would indeed be gains in simplicity.[47] A consumption tax would introduce new complexities although its overall effect is difficult to assess.

Even if a cash-flow consumption tax would be simpler to administer than the income tax or hybrid alternatives, it is not clear such an approach would be desirable. They may be good reasons for choosing income as a base for personal taxation rather than consumption despite any possible gains in simplicity.[48]

Hybrid Approaches

Whatever the merits of a move to achieve a pure income tax or consumption tax, it is unlikely that Congress would be willing to adopt either approach. Congress has been of two minds regarding tax preferences. On the one hand, the idea of using the tax system to implement social programs and achieve economic objectives has proven resilient. The reduction in tax preferences achieved in the 1986 Act was the result of a change in rethinking on the part of tax policymakers regarding the economic wisdom of providing tax preferences for certain forms of capital rather than a disenchantment with using the tax system to achieve economic goals. The recent debate on reinstituting reduced rates for capital gains indicates just how volatile that thinking can be.

On the other hand, Congress has been concerned by reports of high-income taxpayers paying little or no tax. Although this phenomenon is directly linked to existence of tax preferences, Congress has chosen to deal with this problem by implementing separate limitations rather than by repealing tax preferences. Given this state of affairs, it is reasonable to ask what alternatives are available if Congress maintains its desire to continue tax preferences but curb tax shelters.

Repeal the PAL Limitations

The criticisms of the PAL limitations on grounds of both equity and complexity suggest that the outright repeal of these limitations might be appropriate. One might bolster the case for repealing the PAL limitations by pointing to the many changes initiated in 1986 that reduce the prospects for tax shelters even in the absence of specific limitations. It thus might be argued that tax shelters would not reemerge even without specific limitations (and without additional base broadening) because the depreciation allowances, investment credits, marginal tax rates repeal of the PAL rules without substituting other tax shelter limitations should expressly oppose the reintroduction of preferential tax rates for capital gains and other preferences that would increase arbitrage opportunities.

Limitations on Artificial Losses

One alternative to the existing PAL rules is the adoption of a limitation on artificial accounting losses (LAL).[52] The LAL proposal resembles the PAL rules in that certain tax losses from an activity are temporarily suspended. Under LAL, these losses would be deducted against income within that "basket" or from future taxable income from that activity or related activities. Artificial losses would be deductible upon disposition of the investment if not used to offset income. The LA approach differs form the PAL rules in that only artificial accounting losses are suspended. An artificial accounting loss is "that portion of any loss, attributable to an activity or related activities, which would disappear if the taxpayer had no accelerated deductions in the current year.[53]

LAL rules are preferable to PAL rules because they do not require the suspension of real economic losses.[54] The idea of the LAL proposal is to isolate the portion of a loss which is "artificial," thus allowing the deduction of "real" losses. Although the LAL proposal as originally formulated was not comprehensive in identifying artificial losses, the proposal could be modified to correct this problem.

Although the LAL rules are potentially more equitable than the PAL rules because LAL would distinguish real from artificial losses, they would not necessarily promote tax simplification. Distinguishing real from artificial losses would introduce a new significant distinction that would be anything but simple.[55] What portion of existing depreciation deductions is artificial? Even if a table were established making this determination, calculations would be necessary to establish what portion of the nominal tax loss before application of LAL could be deducted.

Some of the complexities of the PAL rules would also arise under LAL. For example, LAL also is predicated upon a basket approach; artificial losses may only be offset against income within that basket. As originally proposed, LAL was directed activities in six specific areas: real estate, farming, oil and gas, equipment leasing, movies, and sports franchises.[56] All real estate activities were to comprise a single basket; losses from one project would be used to offset income from other real estate projects. Similarly, all farming activities could be netted. On the other hand, projects falling within any of the four other areas would comprise a separate basket so that losses could only offset income from that project prior to disposition. What becomes apparent from this description is that the difficulties involved with defining an activity under the PAL rules also are present under an LAL approach.

One major advantage of the LAL approach is that is would not require a determination of whether a taxpayer materially participates. This eliminates that tension felt under PAL between a narrow or broad definition of an activity. Also, limiting only artificial losses, a narrow definition of an activity would seem justified.

LAL thus presents another realistic alternative to PAL. LAL is fairer because it only limits artificial tax losses. LAL is not, however, a simple idea to implement although it is not necessarily any more complex than the PAL rules.

Repeal At-Risk Rules; Retain PALs

Even if tax shelter limitations are desirable and/or politically inevitable, the question arises as to whether we need as many tax shelter limitations as we currently have. If at-risk rules and PALs (not to mention a variety of other limitations) are both designed to limit tax shelter activity, do we need to maintain both sets of limitations?

It is important to note that the at-risk rules serve two separate functions. They are, to be a sure, a limitation on abusive tax shelters. They are designed to prevent the overvaluation tax shelter that became prevalent in the 1970's. By limiting the deductibility of losses attributable to nonrecourse debt in most circumstances, the at-risk seek to prevent the deduction of paper losses that are not likely to be borne by the taxpayer.

But the at-risk rules can also be viewed as a correct income measurement rule. Consider the following example.[57] Assume A purchases a building $1,000,000 financed by $200,000 of A's own funds plus a $800,000 nonrecourse debt. The building has a remaining useful life of 10 years and its value is expected to decrease by $100,000 per year over this ten-year period. After the first year, the building is worth $900,000. A should be entitled

to a $100,000 depreciation deduction representing the decline in value of the building. If the building were sold for $900,000, A would repay the debt (assuming it is still $800,000) and keep $100,000. The same result should obtain for year two.

In year three, the decline in value from $800,000 to $700,000 will not be borne by A because the debt is nonrecourse. A's maximum economic loss from the investment is $200,000 (the sum of A's cash investment ($200,000) and any mortgage amortization (assumed here to be zero)). A has already deducted an aggregate of $2000,000 in years one and two. A should thus not be entitled to a further depreciation deduction in year three. Disallowing any further deduction (except to the extent the mortgage is amortized) is consistent with the theory of at risk.

The question nevertheless remains whether the at-risk rules could be eliminated in the name of simplification. On the one hand, one layer of rules would be eliminated which might reduce compliance complexity (and rule complexity) for those engaged in investments producing tax losses attributable to nonrecourse financing. Eliminating the at-risk rules might, however, increase transactional complexity for taxpayers with passive activity income by providing an avenue for artificially generating losses to offset that income. Although existing rules do not allow the overvaluation of property, at-risk rules simplify the enforcement of these rules. It is difficult to say whether the repeal of the at-risk rules would result in any net simplification of the tax system. Absent any clearly defined gain in simplicity, I favor retention of these rules because they are consistent with the principle of income taxation that a taxpayer should not be entitled to a deduction of a cost that he is not obligate to bear.

SIMPLIFYING PALS

If the current overall structure remains intact and PALs continue as the major way of limiting tax shelters, the question arises as to whether the PAL rules can be simplified. The existing PAL rules are lengthy and complex. The IRS forms and instructions contain six worksheets often requiring many calculations and allocations.[58] Some proposals for simplification have been suggested. This section will evaluate some of these proposals and suggest other changes that might be considered.

Defining "Activity"

The proposed and temporary regulations issued last May principally deal with the definition of an "activity." Income and loss from activities in which a taxpayer materially participates are netted in applying the PAL limitations. There is a tension involved in how broadly or narrowly an activity is defined. If defined narrowly so that small units are treated as separate activities, taxpayers may be able to avoid material participation with regard to income-producing units thereby qualifying such income as passive activity income available to offset passive activity losses. If defined broadly, so that small units are aggregated, taxpayers may be able to aggregate participation for loss-producing units in order to avoid the PAL limitations for these loss units.

The basic approach of the regulations is to provide a broad definition of an activity. The regulations reflect the Treasury's principal concern of preventing taxpayers from offsetting passive losses with income-producing units.[59] Undertakings - the fundamental unit of economic endeavor - are aggregated in a variety of circumstances to produce a single "activity".[60] Loss-producing units which are aggregated will not be available to offset PALs if material participation is achieved.

The "activity" regulations have been criticized on a number of grounds. The major criticisms are that the broad definition of an activity achieved through mandatory aggregation and integration rules is extremely complex and inconsistent with idea of an activity underlying section 469.[61]

To address these criticisms, the ABA Task Force on Passive Losses has recommended that the regulations be amended to create a rebuttable presumption that an undertaking constitutes an activity.[62] Taxpayers taking a position on their tax returns contrary to this rebuttable presumption would be required to indicate this fact on the return. The proposal is described as "far less complex"[63] than the approach taken in the regulations which consists of "more than 100 typed pages"[64] and requires taxpayers to engage in a "multitude of steps"[65] to determine what constitutes the taxpayers' activities.[66] The existing rules are "too complex to understand or obey."[67]

The major feature of the Task Force Proposal is the rebuttable presumption.[68] It is far from clear, however, whether the cause of simplicity would indeed be advanced by the adoption of the Task Force proposal. There are at least two respects in which this proposal contains complexities of its own. First, if an undertaking is not necessarily coterminous with an activity, creating only a rebuttable presumption, against allowing taxpayers or the government to aggregate undertakings may be overcome. The test of whether the enterprise is "an integrated and interrelated economic unit"[69] is shorter but not necessarily simpler. The situation is analogous to the airline pilot example.[70] Just as the test of "unreasonable risk" in determining when an airline pilot should retire is no simpler than the lengthier but more precise alternative, here, too, the shorter, less precise test is not necessarily simpler. If the test is one on "integrated and related economic unit," rules are needed to implement this test. It is hard to understand the simplicity advantages of developing these rules through cases and revenue rulings rather than by regulation. Neither simplicity nor certainty is likely to be served if these rules are developed on a case-by-case basis.

Second, while allowing taxpayers aggregate undertakings on the basis of the facts and circumstances contained in Reg. § 1.469-4T(g) will be applauded as providing flexibility, the decision whether to attempt to aggregate undertakings may not be simple. Alternative calculations under all available alternatives and the planning implications of each are the likely result of making this option available.

I find the idea of allowing either the taxpayer or the Internal Revenue Service to rebut the presumption to be somewhat disingenuous. From the taxpayer's perspective, the presumption apparently could be relied upon as a reporting position to claim that income-producing units are passive and thus may offset passive losses. On the other hand,

taxpayers could claim under amorphous aggregation standards that loss units should be aggregated with other units where material participation is present thus allowing the loss to be deducted. Although the taxpayers in this latter case would have to disclose this position on their return, only a small percentage of these returns could realistically be audited.

The rules could be shortened and somewhat simplified if an undertaking were conclusively established as the definition of an activity.[71] The ABA Task Force rejects this approach as unfair. Although this conclusion is far from obvious,[72] my major criticism of the Task Force is with its claim that a flexible approach is simpler than the approach taken in the regulations.

Simplicity and fairness are often in conflict. Whatever the merits of a broad or narrow definition of an activity, an approach should be determined which is conclusive in the vast majority of circumstances. It is only in this way that any meaningful simplification can be achieved.

Material Participation

Passive activity losses and passive activity income generally arise only if the taxpayer does not materially participate in the activity.[73] The regulations provide that a taxpayer materially participates in an activity if one of seven tests is satisfied.[74] The basic test provides that the taxpayer materially participates if more than 500 hours is devoted to the activity during the taxable year.[75] Moreover, the regulation recharacterize passive activity income as nonpassive income if the taxpayer "significantly participates."[76] Significant participation is achieved through participation of more than 100 hours during the taxable year.[77]

The relatively modest thresholds for qualification under the material participation tests appear consistent with the policy of limiting taxpayers' ability to generate passive activity income which can offset passive activity losses.[78] The low threshold has the effect of characterizing income (and losses) from activities as active.

The material participation regulations have been criticized as inconsistent with Congressional intent. The regulations are said to be inconsistent with Congressional intent both because of the low threshhold[79] and because the tests are mostly quantitative rather than based upon all the facts and circumstances.[80] One critic has asserted that "the fundamental rule for material participation should be the facts and circumstances approach that Congress envisioned."[81]

A facts and circumstances test would be counterproductive to tax simplification. For the reasons stated earlier, such a test creates uncertainty that ultimately will be resolved over time through rulings and cases. A quantitative test should be retained even if it requires statutory modification.[82]

The Netting Approach

A Source of Complexity

Part of the problem with defining an "activity", as discussed above, is concern that taxpayers will be able to generate unrelated passive income to offset their PALs. The PAL rules are based on a netting approach under which passive activity losses may be deducted only against passive activity income. The netting approach include in one basket all passive activities of the taxpayer. Thus, the losses from one investment qualifying as a passive activity may be used to offset the income from other unrelated passive activities. Passive activity losses may not be used to offset portfolio income or wage income other than upon disposition of the investment in the passive activity. Much complexity can result from this type of netting. The complexity may arise from several factors.

First, taxpayers with passive activity losses in excess of passive activity income have an incentive to generate passive activity income from other investments. To the extent that taxpayers are permitted to generate passive activity income that can offset losses, the netting structure produces transactional complexity. The investment decisions of taxpayers with net passive losses are complicated by the potential tax savings that may be achieved by investing in activities producing passive activity income.

The netting rules themselves have been further complicated by statutory and regulatory provisions designed to prevent taxpayers from generating passive activity income in at least some circumstances. Thus, the subsequently enacted publicly-traded partnership rules were created to prevent taxpayers with unallowed passive activity losses from generating passive activity income from investments in publicly-traded partnerships.[83] The significant participation rules also have been structured to deter taxpayers structuring endeavors generating income to qualify as passive activities.[84]

Conversely, because the passive activity basket is kept small in order to make it difficult for taxpayers to characterize income as passive activity income, taxpayers more readily can generate losses that do not qualify as passive activity losses.[85] There are thus inherent limitations in minimizing transactional complexity through a netting approach. Whether the basket is large or small, there will always be planning possibilities.

Netting leads to other complexities as well. The application of the netting rules may produce significant compliance complexity for some taxpayers. By generally placing all investments qualifying as passive activities in one basket, losses may have to be allocated among passive activities in some circumstances. Worksheets 4 through 6 to Form 8582 are the product of the netting rule which allows the passive income from one activity to offset the passive losses from other passive activities. These rules allocate the disallowed loss to each passive activity showing an overall 1055.[86]

Limiting Netting to Income From That Activity

The complexities described above might be reduced by changing the netting approach to permit losses from a passive activity (prior to disposition) to be deducted only

against income from that activity.[87] If the definition of an activity were narrowed significantly as well, taxpayers would no longer be able to structure their investments in order to produce income from a separate activity that could be used to offset passive activity losses.[88] Moreover, allocations of disallowed losses among activities would no longer be necessary. Furthermore, rules such as the publicly-traded partnership rules and recharacterization rules[89] designed to prevent the generation of passive activity income would also become superfluous.

There are, however, several reasons why this alternative might not be desirable. Some complexity might be created by disallowing some losses for longer periods of time thus requiring taxpayers to maintain records for that longer period. Also, if an activity were defined more narrowly as part of this approach, complexity might be increased by attempts to manipulate the material participation requirement.

But the major reason why this proposal would be undesirable is that the passive activity loss provisions limit the deductibility of real as well as artificial losses. Where the suspended losses do not represent a current economic loss, the accurate measurement of income would be served by this more restrictive netting rule. Thus, for example, assume a taxpayer has investments in two passive activities, one showing taxable income of $10,000. If the tax loss does not reflect an economic loss, then the two investments should result in net income for tax purposes of $10,000; the $10,000 loss should not be deducted. If, on the other hand, the $10,000 does represent an economic loss in full, then deductibility would achieve a correct measurement of income.[90] Unlike the LAL proposal, the passive activity rules do not attempt to distinguish economic losses from losses that do not represent a current economic loss. Preventing taxpayers from using passive income from other economic units to offset passive losses might increase the unfairness of the PAL provisions. It is thus difficult to evaluate the extent to which the more restrictive rule would improve or distort the measurement of income. All in all, I would not advocate this approach because of the potential reduction in fairness it might cause.

The Phase-In Rules and Rental Real Estate Losses

In looking at Form 8582, many of the computations on the Form (excluding the computations on the worksheets which are discussed below) result form (1) distinguishing passive activities acquired before October 23, 1986 from those acquired after this date; and (2) distinguishing rental real estate activities with active participation from other passive activities. The first distinction will continue to be relevant only through 1990 when the phase-out of losses from activities acquired before October 26, 1986 is complete. If the special $25,000 maximum allowance for certain rental real estate activities with active participation were also eliminated, one could envision Form 8582 with a total of 5 or 6 lines (lines 2d, 2e, 2f, 2h, plus a line or two for allowing the losses to the extent of the passive income if the current netting rules remain (the equivalents of lines 18 and 19)).

The Form itself, of course, is only part of the story. The current instructions to Form 8582 contain six worksheets (in addition to worksheets A and B dealing with publicly-traded partnerships). Many of the computations on these worksheets (other than the

computations resulting from the netting rules as discussed above) would likewise be eliminated if the two distinctions referred to above were eliminated. Worksheets 1 and 3 deal exclusively with rental real estate activities involving active participation; they would not be necessary if the special allowances for these losses were eliminated. Half of worksheet 2 involves the phase-in distinction and similarly would no longer be necessary if this distinction were eliminated (or allowed to expire).

The allowances of losses involving pre-October 23, 1986 losses and rental real estate where the taxpayer actively participates also complicate the allocation rules of Worksheets 4, 5, and 6. Computing the unallowed loss to be allocated requires computing the allowed loss and subtracting the latter from the total loss. More significantly, some of the more common situations where the allocation of deductions within an activity may affect the taxpayer's liability involve rental real estate activities.[91]

Allocating Interest

Because the PAL rules establish a separate category for passive activity income and loss, it may be necessary for a taxpayer to allocate interest expense between passive activities and other activities.[92] Section 469(1)(4) provides Treasury with the authority to issue regulations providing for "the determination of the allocation of interest expense for purposes of this section." Proposed and temporary regulations have been issued which provide that this allocation is to be made by tracing loan proceeds according to the use.[93]

These rules are a potential Achilles' heel of the basket approach. A tracing rule has the potential for serious manipulation. Alternatives to a tracing approach also present difficulties.[94] It is possible that the complexities of borrowing money for the purpose of increasing passive activity losses are sufficient to deter this behavior. For whatever reason, the practitioners I have spoken with have not provided evidence that the interest allocation rules have resulted in transactional complexity of this sort.

Working Interests

The existing PAL rules exclude working interests in oil and gas properties from the definition of passive activity.[95] To qualify, the working interest cannot be held through an entity that limits the taxpayer's liability[96] although the taxpayer can be protected through an indemnification or stop-loss arrangement.[97] The exception for working interests is contrary to the purposes of the PAL rules and inconsistent with the other portions of these rules. Taxpayers should not be allowed to shelter other income with losses from working interests. Transactional complexity would be reduced by repealing this exception.

Conclusion

The prospects for significant simplification of the PAL rules are not good. There are inherent complexities in any approach which creates a basket where losses can only be

netted against gains within that basket. If the basket is small, too much escapes. If the basket is large, it becomes too easy to generate income to offset the losses. In either case, significant transactional complexity results. Rules also must allocate interest expense between the basket and other items. The PAL rules have the added problem of defining material participation as part of the definition of the basket.

Proposals to eliminate the existing detailed rules and substitute facts and circumstances tests would not simplify the rules. Shorter rules are not necessarily simpler. Criteria are needed to provide answers to a myriad of facts and circumstances. Much regulatory detail is responsive to taxpayers' desire for certainty.

The existing rules are unquestionably complex. I wish there were a fair way to provide significant simplification. For the reasons stated above, I do not see how this may be accomplished within the context of the PAL concept.

CONCLUSION

The best prospect for simplification would be to maintain or expand the tax base so that the PAL limitations could be repealed without providing a fertile climate for tax shelters. Proposals such as the restoration of capital gains preferences or the indexation of capital gains without the indexing debt are inconsistent with the repeal of PAL limitations and may serve as a harbinger of future tax preferences.

The limitation on artificial accounting losses has potential as an alternative to the PAL rules. LAL would not be simple but would offer the advantage of only limiting artificial losses. Under a LAL approach, it would be possible to provide a narrow definition of activity and limit the deductibility of artificial losses to income from other economic units. Distinguishing real from artificial losses, however, would be a source of complexity.

It is difficult, in my opinion, to significantly simplify the PAL rules. Although changes could be made to the rules regarding working interests and real estate loss deductions for taxpayers who actively participate, much of the complexity of the PAL rules results from difficulties inherent in the PAL concept. Significant simplicity could be achieved only at the risk of increasing the inequities of the PAL limitations. Although the rules could be significantly shortened, as proposed by the ABA Task Force, significant complexity would remain.

ENDNOTES

[1] As originally enacted, the at-risk rules applied only to the four types of activities specified in section 465(c) (1). The Revenue Act of 1978 extended the at-risk rules to all types of Business or investment activity except real estate. It also extended the at-risk rules to corporations owned (directly or through attribution) by five or fewer shareholders except for certain types of equipment leasing activities. The Tax Reform Act of 1986 extended the at-risk rules to Real estate activities by repealing the exception provided in § 465(c)(3)(D). A special exception, however, treats "qualified nonrecourse financing" secured by real property as an amount at risk. This exception is intended to limit "the opportunity for overvaluation of property," by distinguishing arm's-length borrowings from borrowings that may not represent a true indebtedness. See H.R. Rep. No. 426, 99th Cong., 1st Sess., at 293 (1985). For a discussion of the details of these rules, see Note, Risky Business: The Extension of the Section 465 - At-Risk Rules to Real Estate Under the Tax Reform Act of 1986, 8 VA. TAX REV. 209, 218-220 (1988).

[2] The first set of proposed and temporary regulations, issued on February 19, 1988, provides rules for computing passive activity losses and credits, defines various terms including "trade or business activity," "rental activity," and "material participation," and explains the operation of the phase-in provisions. The second set of regulations, published May 12, 1989, principally deals with defining an "activity."

[3] See Peroni, A Policy Critique of the Section 469 Passive Loss Rules, 62 U. SO. CAL. L. REV. 1, 67-69; 95-102 (1988); Zelenak, When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986, 67 TEXAS L. REV. 499, 554-55; 566-88 (1989); Solomon, The 1988 Temporary Passive Loss Regs Revisited: What a Tangled Web They Weave, 13 REV. OF TAX. OF INDIV. 195 (1989).

[4] See Bittker, Tax Reform and Tax Simplification, 29 MIAMI L. REV. 1 (1974).

[5] See FEDERAL INCOME TAX SIMPLIFICATION 85-89; 507-57 (C. Gustafson ed. 1979); Committee on Tax Policy, New York State Bar Association, Tax Section, A Report on Complexity and the Income Tax 27 TAX L. REV. 325, 336-73 (1972)[hereinafter "New York State Bar Committee Report"]; Eustice, Tax Complexity and the Tax Practitioner, 8 TAX ADVISER 27, 29-31 (1977).

[6] New York State Bar Committee Report, supra note 5, at 328-31.

[7] See, e.g., Manning, Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385, 36 TAX LAW. 9 (1982).

[8] A study conducted by an eminent group of tax lawyers focussed upon complexity arising from the fact that: (1) A reasonably certain conclusion cannot in some instances be determined despite diligent and expert research; and (2) a reasonably certain conclusion can be determined in other instances only after an expenditure that is excessive in time and

dollars. See New York State Bar Committee Report, supra note 5, at 336-73. As discussed below, and as recognized by the New York State Bar Committee Report, the issue of complexity under the tax laws is far broader than the "rule complexity" with which the Report deals.

[9] See Manning, supra note 7.

[10]See New York State Bar Committee Report, supra note 5 (recommending the formation of a commission to make specific recommendations for simplifying the income tax). In response to this recommendation, Professor Eustice has quoted a poem by A.P. Herbert:

> ... I am the Royal Commission on kissing established by Gladstone in '75; all the others are dead or missing, I am the only one left that's alive; but still I'm a Royal Commission, my work I intend to see through; though I know as an old politician, not a thing will be done if I do.

Eustice, supra note 5, at 34.

[11]For a discussion on the extent to which the proposed comprehensive income tax proposed in Blueprints for Tax Reform would result in increased simplification or increased complexity, see Galper & Kaufman, Simplification and Comprehensive Tax Reform, in FEDERAL INCOME TAX SIMPLIFICATION, supra note 5, at 161.

[12]See Surrey, Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail, 34 LAW AND CONTEMP. PROB. 673, 673-77 (1969).

[13] See, e.g., FEDERAL INCOME TAXATION, supra note 5, at 94 (ABA-AICPA Conference on Tax Simplification did not make a substantive recommendation on the proposal to eliminate the rate differential on capital gains because the issue "will ultimately be grounded on policy considerations other than simplification").

[14] Brannon, Simplification and Other Tax Objectives, in FEDERAL INCOME TAX SIMPLIFICATION supra note 5, at 191 (treating complexity as a type of resource misallocation to be factored into the tradeoff between equity and efficiency).

[15] See D. Bradford, UNTANGLING THE INCOME TAX 266-67 (1986).

[16]It is assumed that the exclusions, deductions or credits which produce the different effective tax rates are not fully capitalized into the cost of the investment. For a discussion of the extent to which capitalization occurs, see Koppelman, Tax Arbitrage and the Interest Deduction, 61 5. CAL. L. REV. 1143, 1172-92 (1988).

[17] D. Bradford, supra note 15, at 267.

[18] See D. Bradford, supra note 15, at 266-67; Peroni, supra note 3, at 68.

[19] See Hickman, Capital Gains and Simplification, in FEDERAL INCOME TAX SIMPLIFICATION, supra note 5, at 223 (arguing that the repeal of the then preferential rates for capital gains would not necessarily lead to simplification).

[20]The following example appears in Diver, The Optimal Precision of Administrative Rules, 93 YALE L. J. 65 (1983). Although Diver's analysis is directed at the optimal precision of administrative rules, his analysis can usefully be applied to the combination of statutory and administrative rules. I intend to apply Diver's analysis to tax rules in this broader context.

[21] Id. at 69.

[22] Id.

[23] Id.

[24] Id. at 70.

[25] Reg. § 1.469-5T(a)(1) - (a)(6).

[26] Reg. § 1.469-5T(a)(7). The specifics of this test have been reserved for future regulations.

[27] See, e.g., Staff of the Joint Committee on Taxation, PROPOSALS RELATING TO TAX SHELTERS AND OTHER TAX-MOTIVATED TRANSACTIONS (February 17, 1983); S. Surrey, PATHWAYS TO TAX REFORM, 92-125, 258-67 (1973); W. Andrews, FEDERAL INCOME TAXATION 1362-68 (1985).

[28] See Press Release of July 8, 1982, by Congressman Rangel, Chairman, Subcommittee on Oversight, Committee on Ways and Means (announcing hearings on abusive tax shelters).

[29] In its broadest sense, tax arbitrage refers to any investment which generates a profit because one part of the transaction is taxed differently from the other part. Combining deductible interest with tax-preferred assets is by far the most common form of tax arbitrage. See Koppelman, supra note 16, at n.12. See also C. Steuerle TAXES LOANS AND INFLATION 57-60; and Bradford, The Economics of Tax Policy Toward Savings, in 2 THE GOVERNMENT AND CAPITAL FORMATION 11, 41 (G. Von Furstenberg ed. 1980).

[30]See generally McMahon, Reforming Cost Recovery Allowances for Debt Financed Depreciable Property, 29 ST. LOUIS U.L.J. 1029 (1985); Johnson, Tax Shelter Gain: The Mismatch of Debt and Supply Side Depreciation, 61 TEX. L. REV. 1013 (1983); Koppelman, supra note 16. These arguments as well as the arguments against imposing limitations on tax arbitrage are provided in Warren, Accelerated Capital Recovery, Debt, and Tax Arbitrage, 38 TAX LAW. 549 (1985).

[31] See Koppelman, supra note 16, at 1202-03.

[32] See Mundstock, Accelerated Depreciation and the Interest Deduction: Can Two Rights Really Make a Wrong? 29 TAX NOTES 1253 (1985).

[33] See Hickman, Interest, Depreciation, and Indexing, 5 VA. TAX REV. 773, 787-91 (1986).

[34] Other significant changes were also made in the 1986 Act including the removal or reduction of many provisions inconsistent with the measurement of economic income and the reduction in marginal tax rates.

[35] Taxpayers may shelter trade or business or wage income with losses from activities in which they materially participate and which thus do not qualify as passive activities.

[36] § 469(i).

[37] § 469(c) (3).

[38] § 469(i) (6) (B).

[39] § 56-59.

[40] § 163(d).

[41] See, e.g., Peroni, supra note 3; Solomon, supra note 3.

[42] On a theoretical level, the case for restricting tax shelters without eliminating preferences is not persuasive.... A provision drafted broadly enough to disallow all artificial losses will inevitably disallow some real losses, while a provision designed to allow the deduction of real losses will inevitably allow the deduction of some artificial losses.... These objections extend beyond flaws peculiar to the provisions of the 1986 Act; they suggest problems likely to beset any attempt to eliminate shelters without eliminating preferences.

Zelenak, supra note 3, at 588-89.

> [T]his Article concludes that section 469 should be repealed or, at the very least, substantially modified. In its place, Congress should continue the politically difficult, but important, task for attempting to eliminate, or substantially limit, the remaining tax preference in the Code that give rise to artificial tax shelter losses, including devising a system of economic depreciation that accurately measures income.

Peroni, supra note 3, at 6.

[43] Tax preferences by their very nature represent departures from the definition of economic income. For a discussion of some reasons that have been advanced for this distinction, see Zelenak, supra note 3, at 502-08.

[44] The administrative difficulties of taxing all economic income when it accrues make the elimination of all preferences unlikely.

[45] Some practitioners have told me they believe that even modest discrepancies between economic income and taxable income can be parlayed by sophisticated parties into attractive tax shelters absent specific limitations such as PALs. The use of leverage and special allocations of partnership losses are but two provisions that could be used to magnify benefits to investors. There is no concrete evidence supporting this view. Life without tax shelter limitations would, of course, require careful monitoring.

[46] See D. Bradford, supra note 15, at 266-81; Andrews, A Consumption-type or Cash Flow Personal Income Tax, 87 HARV. L. REV. 1113, 1140-48 (1974); McLure, The 1986 Act: Tax Reform's Finest Hour or Death Throes of the Income Tax, 41 NAT'L TAX J. 303 (1988).

[47] See American Bar Association, Section of Taxation, Committee on Simplification, Complexity and the Personal Consumption Tax, 35 TAX LAW. 415 (1982).

[48] See Warren, Fairness and a Consumption-Type or Cash Flow Personal Income Tax, 88 HARV. L. REV. 931 (1975).

[49] See C. Steuerle, supra note 29.

[50] In the context of activities now covered by § 469, the tax shelter potential would arise from the reduced rates on dispositions covered by 1231.

[51] The Treasury Department proposal that culminated in the 1986 Act recommended that debt be indexed. See U.S. Treasury Department, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH (1984). Indexing debt (and the basis of assets) would introduce significant complexity.

[52] For the genesis and development of the LAL proposal see Peroni, supra note 3, at 15-18.

[53] U.S. TREAS. DEPT., PROPOSALS FOR TAX CHANGE 94-104 (April 30, 1973).

[54] See Peroni, supra note 3, at 104.

[55] See Zelenak, supra note 3, at 585-86. The PAL rules rely on the distinction between activities in which the taxpayer "materially participates" and those in which the taxpayer does not so participate. Although this distinction, to be sure, has complexities of its own, the distinction is relevant to far fewer taxpayers than would be affected by the distinctions inherent under LAL.

[56] See generally H.R. REP. NO. 658, 94th Cong., 1st Sess. 25-28 (1975). See also Zelenak, supra note 3, at 569.

[57] This example appears in a substantially similar form in S. Surrey, P. McDaniel H. Ault, & S. Koppelman, FEDERAL INCOME TAXATION 1025 (Successor ed. 1986).

[58] See McBride, Six to One: Replacing the IRS PAL Worksheets, 43 TAX NOTES 597 (1989).

[59] The principal draftsman of these regulations has acknowledged this view. See Sheppard, Gimme Shelter, One More Time: The Definition of Activity Rules, 44 TAX NOTES 1191, 1195 (1989).

[60] Taxpayers may elect to disaggregate for purposes of the disposition rules under section 469(g).

[61] See American Bar Association, Section on Taxation, Task Force on Passive Losses, Preamble to the Comments on Activity Regs, 44 TAX NOTES 1277 (1989) (hereinafter "Preamble"). Lipton, PALs at Three: What We Know, What We Don't Know And What Went Wrong, 67 TAXES 715, 718-25 (1989).

[62] See Preamble, supra note 61, at 280-81; see also Lipton, supra note 61, at 725.

[63] Preamble, supra note 61, at 1280.

[64] Id. at 1278.

[65] Id.

[66] The Task Force Comments state that "[f]rom a compliance standpoint, this proposal will eliminate the need for special rules involving aggregation, integration, and professional service undertakings". Id. at 1281.

[67] Id. at 1279.

[68] Two Task Force members have stated that "rebuttable presumptions are facts and circumstances tests are a necessary feature of sound tax policy because such rules allow the economic substance of a transaction to govern its tax treatment." Evaul & Wallace, Passive Activity Losses: Definition of an Activity, 44 TAX NOTES 1257, 1262 (1989).

[69] Id. at 1279.

[70] See text accompanying notes 20-26.

[71] The definition of an undertaking be modified if it were to serve as the definition of an activity. One modification might be to eliminate the idea that each interest in each separate passthrough entity constitutes a separate activity regardless of its relationship to other interests.

[72] Although a facts and circumstances test might be fairer in theory, I fear that the audit lottery would in practice reduce this test to an election for taxpayers to choose or reject aggregation.

[73] A separate rule is provided for rental activities which are treated as passive regardless of whether the taxpayer materially participates. §469(c)(2). Losses may be deducted to a limited extent in such cases if the taxpayer actively participates in the rental activity. § 469(i).

[74] Reg. 1.469-5T(a)

[75] Reg. 1.469-5T(a)(1). Among the other tests are that material participation occurs if the taxpayer performs substantially all of the participation in the activity (Reg. § 1.469-5T(a)(2)); if the taxpayer participates for more than 100 hours and at least as much as any other participant (Reg. § 1.469-5T(a)(3)); or if the taxpayer participates for at least 100 hours and material participation is determined on the basis of all the facts and circumstances (Reg. 1.469-5T(a)(7)).

[76] Reg. 1.469-2T(f) (2).

[77] Reg. 1.469-5T(c) (2).

[78] See Lipton, supra note 61, at 727.

[79] See Lipton, supra note 61, at 727.

[80] See Lipton, supra note 61, at 726-27. The Senate Finance Committee Report indicated that "the presence or absence of material participation generally is to be determined with reference to all the relevant facts and circumstances." Senate Committee on Finance, REPORT ON TAX REFORM ACT OF 1986, S. REP. NO. 313, 99th Cong., 2d Sess. 732 (1986); See Zelenak, supra note 3, at 556.

[81] Lipton, supra note 61, at 727.

[82] Whether the regulations are invalid is beyond the scope of this paper. The main point is that a facts and circumstances test makes application of the material participation test more complicated than the tests now contained in the regulations.

[83] Code § 469(k).

[84] Reg. § 1.469-2T(c) and (f).

[85] See Preamble, supra note 61, at 1280.

[86] Reg. § 1.469-1T(f)(2)(i). These rules also allocate the loss for each activity to the deductions for that activity where an allocation affects the income tax liability of the taxpayer. Reg. §1.469-1T(f) (2) (ii) (A). The following illustration is taken from Example 1 of Reg. § 1.469-1T(f)(2)(i)(D). Assume a taxpayer has three investments qualifying as passive activities. The first has a tax loss (before the application of section 469) of $9,000; the second a loss of $16,000; and the third shows taxable income of $4,000. Under the netting rules, the losses of $25,000 (the $9,000 loss plus the $16,000 loss) may be deducted to the extent of the $4,000 passive income. Thus, $21,000 of losses are disallowed for year and must be carried over to future years. Under this example, the disallowed loss must be allocated between the two investments showing a loss. The regulations provide that losses are allocated to each of these two investments equal to that portion of the $21,000 disallowed loss representing the fraction where the numerator is the loss from that investment and the denominator is the total loss from both activities before the netting rules are applied. Reg. §1.469-1T(f) (2) (A). Thus, the disallowed loss for investment one is $21,000 X $9,000/$25,000 = $7,560. The disallowed loss for the second investment is $21,000 X $16,000/$25,000 = $13,440.

[87] I do not necessarily mean to suggest that an "activity" under this alternative be defined in the same way as provided in Reg. § 1.469-4T. Indeed, the goals of this alternative may be better served by defining an activity similar to the way in which an "undertaking" is defined in the regulations.

[88] I have no evidence that taxpayers are currently investing in PIGs (passive income generators) in order to offset PALs. Some practitioners have suggested to me that the combination of the publicly-traded partnership limitations and the relatively low marginal tax rates have made PIGs presently unattractive.

[89] Reg. § 1.469-2T(f).

[90] One might wish to consider the taxpayer's income tax posture with regard to items other than passive activities before reaching this conclusion. Thus, disallowance of the loss could be justified if the taxpayer had significant economic income that was not included in income for tax purposes such as unrealized appreciation.

[91] Reg. § 1.469-1T(f) (2) (iii).

[92] See Zelenak, supra note 3, at 562-66.

[93] Reg. 1.163-8T(c) (1).

[94] See Koppelman, supra note 16, at 1207-16.

[95] § 469(c) (3) and Reg. § 1.469-1T(e) (4).

[96] Id.

[97] Reg. § 1.469-1T(e)(4)(v)(B).

COMMENTS ON "AT-RISK AND PASSIVE ACTIVITY LIMITATIONS - CAN COMPLEXITY BE REDUCED?"

SALLY M. JONES*

THE CURRENT STATUS OF TAX COMPLEXITY

Given the current state of affairs, Professor Koppelman's observation that "there is no generally accepted definition of complexity with regards to taxation" seems pedantic. Perhaps tax professionals cannot define the term or precisely distinguish between compliance, rule, or transactional complexity. There is, however, a universal sentiment that the federal income tax system has become unwieldy to the point of being unworkable.

Evidence of this sentiment is everywhere. James Eustice spoke for every tax educator when he observed that "whole new courses in the Tax curriculum may well be unteachable in a meaningful way, and I am omitting vast segments of the law that I can no longer stand, understand, or certainly communicate to my increasingly befuddled students."[1] What makes this observation particularly poignant is that Professor Eustice wrote it in 1976.

Practicing accountants and lawyers openly acknowledge that there are no longer any tax generalists. A professional who desires to maintain a reasonable level of competency must specialize in a narrow area of the law. Today's myopic expert on the taxation of corporate/shareholder transactions might be confident enough to claim mastery over the 126 pages of subchapter C. Just don't expect him to comment on the other 6,354 pages in the Internal Revenue Code. Members of large national or regional firms can draw upon the selective expertise of their numerous colleagues or their national offices when dealing with complicated client situations. However, small independent firms or sole practitioners with no similar intelligence network are in desperate straits indeed.

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Every student of the federal tax system acknowledges that much of its complexity is a necessary by-product of congressional determination to make the system equitable. Each sentence of statute added to make the law more fair in its application to a particular situation increases the body of knowledge that tax professionals must master. A second root cause of complexity is the use of the federal tax system as an instrument of fiscal policy. Every statutory provision enacted in order to influence the social, financial, or economic behavior of taxpayers requires an additional investment of intellectual resources by those of us who must interpret and apply the provision.

Professor Koppelman summarizes these tradeoffs in his conclusion that a "complex rule often is the result of the failure to accept a simpler rule which is considered less fair or efficient. It well may be difficult to achieve the goals of an income tax without a certain amount of complexity." This traditional defense of complexity has its limits. At some point, the cost of an incremental increase in complexity must surely outweigh the benefit of the corresponding increase in either equity or efficiency. Perhaps if the human mind had unlimited capacity for absorption of knowledge, this point of diminishing return might never be reached. However, there seems to be a widespread belief that the current tax system is on the downward slope of the complexity/benefit curve.

One symptom of the current malaise is that many statutory and regulatory rules are either not applied at all or applied in an incorrect and inconsistent manner across taxpayers. In such cases, the intended result of the particular rule--be it equity or efficiency--cannot possibly be achieved, and may even be perverted. As another commentator has observed, this chaotic state of uncertainty undermines the self-assessment system and rewards "uninformed, adventuresome, and dishonest taxpayers and their tax advisors who are all too willing to take advantage of the uncertainty and play the audit lottery."[2]

REDUCING COMPLEXITY AT THE SOURCE

The Internal Revenue Code is replete with provisions that apply only to specialized economic or financial activities, and each provision can be justified on some macroeconomic basis. (The extractive industries need help in attracting investment capital; ergo, percentage depletion will selectively decrease the tax burden and increase the rate of returns these industries can offer potential investors.)

These provisions, generically described as tax preferences, are designed to induce a particular behavioral response from taxpayers. Over the last twenty years, Congress has developed a concern (some might say paranoia) that certain taxpayers are responding with too much enthusiasm. By indulging in tax-favored activities, these taxpayers are perceived as avoiding payment of their fair share of taxes. Congress has reacted to this perception problem by enacting various limitations on the benefits that can be derived from tax preferences in a given year by any one taxpayer. Thus, the tax laws can be viewed as a carrot and stick system that tempts taxpayers to behave in a certain manner, then flogs them for doing so.

One approach to reducing the current level of complexity in the tax system is suggested by the adage that an ounce of prevention is worth a pound of cure. Rather than enacting a new tax preference and simultaneously weaving a complicated web of limitations on its use, Congress should ignore the fiscal temptation to enact the preference in the first place. If too many taxpayers seem to be bent on the exploitation of an existing preference, Congress should seriously consider repealing the preference rather than concocting a series of exceptions to its availability.

The Tax Reform Act of 1986 adopted this approach in its repeal of the investment tax credit and its modification of the Accelerated Cost Recovery System. The Act's dramatic reduction in the progressive rate structure was equivalent to a reduction in the value of virtually every remaining tax-preference item. These changes theoretically eliminated a significant amount of incentive to invest in tax-favored activities. In this improved tax environment, statutory provisions to limit abusive shelter opportunities logically could be de-emphasized. Congress was apparently unpersuaded by this logic, and enacted the section 469 passive activity loss limitations for good measure.

SIMPLIFICATION OF THE PASSIVE ACTIVITY LOSS LIMITATION

Section 469 clearly strikes at the heart of deferral-driven tax shelters. No longer will taxpayers be motivated to invest in business activities that generate front-end losses in order to deduct those losses against salary or investment income. Professor Koppelman may be correct in asserting that "the success of these rules in squelching complex tax shelter investments has simplified the investment decisions for many high-income taxpayers." However, it is clear that section 469 and the accompanying Treasury regulations add a new dimension of complexity to the tax system. If section 469 is to be accepted as a permanent component of the system, what specific steps can be taken to simplify its structure and, thereby, its application?

In its present form, section 469 provides for a netting process whereby losses from one passive activity may be deducted against income or gains from other passive activities. Theoretically, this netting process can be criticized as a half measure. Congress could more completely reduce the shelter potential of passive activities by revising section 469 to provide that losses generated by an activity are only deductible against income or gain from that activity (the current rule for publicly traded partnerships). This tax treatment for losses generated by passive activities roughly corresponds to the treatment of equity investments in C corporations. Losses from the corporate business do not flow through as a deduction to the investing shareholders. An economic loss on the investment is only deductible when it is realized upon a taxable disposition of the shares.

While an activity specific loss limitation would be more restrictive than current law, it would end the need for allocation of the net passive activity loss for a year to each passive activity owned by the taxpayer. The procedure for deductibility of suspended losses upon a taxable disposition of a passive activity would be simplified. Finally, the repeal of the netting concept would eliminate the artificial tax incentive to invest in passive income

generators (PIGs), the income from which currently has the unique ability to shelter passive activity losses.

Repeal of the $25,000 exception for rental real-estate activities would obviously result in a major simplification of section 469. The Senate Finance Committee Report on the Tax Reform Act of 1986 defends this exception to the passive activity loss restrictions as "appropriate in the case of certain moderate-income investors in rental real estate, who otherwise might experience cash flow difficulties with respect to investments that in many cases are designed to provide financial security, rather than to shelter a substantial amount of other income."[3] It is impossible to assess quantitatively whether the benefit of the rental real-estate exception to the targeted taxpayer group outweighs the cost of its complexity. However, it is certainly arguable that repeal of the exception would focus the attention of moderate-income taxpayers on the pre-tax cash flow generated by real estate investments and would ultimately result in investment decisions based upon economic rather than tax considerations.

THE PASSIVE ACTIVITY REGULATIONS

Much of the complexity in the application of section 469 is attributable to the first two sets of Treasury regulations. Another author has observed that "there are now roughly 560 pages of far-ranging and, some would argue, overly broad rules. To add insult to injury, the PAL regulations aren't even half complete yet. There are at least five more PAL regulation installments expected. That's a lot of effort devoted to the problem of abusive tax shelters--a problem that many commentators believe is largely a historic one!"[4]

In drafting the section 469 regulations, the Treasury clearly is working on the premise that more is better. For example, Temp. Reg. sec. 1.469-5T provides guidance as to the meaning of the statutory term "material participation." The regulation provides that an individual shall be treated as materially participating in an activity if based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year. The regulation fails to specify which facts and circumstances will be controlling--such specification is reserved for a future date. In addition to this subjective description, the regulation goes on to provide six additional safe-harbor tests for material participation. These tests introduce two new terms--"significant participation activity" and "personal service activity"--the definitions of which must be mastered before the safe-harbor tests can be applied.

In its determination to provide detailed guidance to taxpayers, the Treasury seems to have lost sight of the fact that having too much information can be as detrimental to effective decision-making as too little information. Information must be manageable to be useful, and no tax practitioner today would describe the section 469 regulations as manageable in any sense of the word. The end result of the Treasury's labors may be that "many advisors, despairing of the increasing-length and complexity of the passive loss regulations, will be tempted to ignore them or to apply them only generally."[5]

Professor Koppelman points out that the Treasury faced conflicting objectives when drafting the regulations that define the key term activity. Certainly, the definition should be narrow enough to isolate all potential tax-sheltering loss activities. However, Treasury also wanted a definition broad enough to limit a taxpayer's ability to generate passive income within his line of business. For example, consider a taxpayer who invests in a Chicago restaurant business and materially participates in daily operations.[6] The business purchases a restaurant in St. Louis, and our taxpayer has no involvement at all in its operations. A narrow definition would treat the St. Louis business as a separate activity, so that losses generated by that business would be passive to the taxpayer. Conversely, if the St. Louis restaurant were profitable, it would become a PIGs under the narrow definition. If the definition of activity were broadened so that the two restaurants are considered a single activity, the taxpayer would be deemed to materially participate in both and have no possibility of passive activity income.

Congressional intent, as reflected in the Senate Finance Committee Report, was to define a section 469 activity in a narrow manner.[7] The regulations, with their aggregation rules for commonly controlled entities, provide a surprisingly broad definition. This confusing situation is a result of the current structure of section 469 that allows netting of gains and losses from all passive activities. If the netting concept were replaced with an activity-specific loss limitation, taxpayers would have no incentive to invest in PIGs. Thus, the Treasury would no longer be whipsawed by the need to prevent passive income through a broad definition of activity. (In the example, the identification of the St. Louis restaurant as a separate, profitable activity in which the taxpayer did not materially participate would be irrelevant in applying the passive activity loss limitation to other activities.) The regulations could be based on the single objective, consistent with congressional intent, to define activity in a narrow manner, and thus could be considerably simplified.

REPEAL OF THE AT-RISK RULES

In his paper, Professor Koppelman defends the section 465 at-risk limitation as a correct income-measurement rule. He uses an example involving a taxpayer A with $200,000 of equity in a $1,000,000 building subject to an $800,000 nonrecourse mortgage. The building has a remaining useful life of ten years, and its value is expected to decrease by $100,000 per year over this period. Professor Koppelman states that A should be entitled to an annual $100,000 depreciation deduction representing the decline in value of the building for years 1 and 2. "In year 3, the decline in value from $800,000 to $700,000 will not be borne by A because the debt is nonrecourse. A's maximum economic loss from the investment is $200,000 (the sum of A's cash investment [$200,000] and any mortgage amortization [assumed here to be zero]). A has already deducted an aggregate of $200,000 in years 1 and 2. A should thus not be entitled to a further deduction in year three. Disallowing any further deduction (except to the extent the mortgage is amortized) is consistent with the theory of at-risk."

There are several problems with this interpretation of the at-risk rules. First, the ACRS deduction allowed under section 168 is based on a cost recovery concept and is not an attempt to track the decline in the economic value of the depreciable asset. In many cases, the economic value of an asset is actually appreciating during the years during which a section 168 deduction may be claimed. Thus, it is the allowance of an arbitrary cost-recovery method that creates the benefit of a tax deduction before any economic loss associated with an asset is accrued or realized.

Second, there is no possibility in Professor Koppelman's example that the taxpayer's ownership of the asset will result in a net deductible loss in excess of $200,000. Even if the taxpayer deducts $1,000,000 of depreciation over the ten-year life of the asset, sale or exchange of the asset will trigger a minimum gain of $800,000 (i.e., the amount realized upon disposition may never be less than the relief of the nonrecourse debt). No tax-planning technique (short of death) can eliminate this phantom gain from A's future. Consequently, the concern over a current deduction in excess of a taxpayer's amount at-risk must be recognized as a timing issue.

Because both the at-risk rules and the passive activity loss rules deal with the taxable year in which a loss is deductible, redundancy in their application is unavoidable. Professor Koppelman makes this point indirectly in his statement that "the at-risk rules were largely a response to abusive tax shelters involving the overvaluation of depreciable property through nonrecourse debt. PALs, on the other hand, were created to defeat the sheltering of virtually all tax shelters, whether regular or abusive."

To illustrate the overlap in the two limitations, assume that an individual purchases an interest in a passive activity for $300,000, using $50,000 of his own funds and financing the balance with a $250,000 nonrecourse debt secured by the interest. In the first year, the activity generates a $90,000 loss to the taxpayer. The at-risk rules would allow the taxpayer to deduct only $50,000 of this loss, with the $40,000 excess carried forward into future years until the taxpayer's at-risk amount again becomes positive. However, the $50,000 deduction now must run the gamut of section 469. If the taxpayer does not own any PIGs, the $50,000 loss will be disallowed and carried forward into future years until passive activity income is generated. The end result of the application of both the at-risk rules and the passive activity loss rules is that the full $90,000 loss is disallowed, but that the taxpayer has two different loss carryforward accounts to track.

Assume that in year 2, the taxpayer abandons the activity. His relief of the $250,000 nonrecourse debt in excess of his $210,000 adjusted basis in the investment (original $300,000 cost less $90,000 allocated loss) results in a $40,000 recognized gain. This gain represents an amount at-risk, which allows him to deduct his $40,000 suspended section 465 loss. This loss spills over and becomes a current loss subject to the passive-activity loss rules. However, the abandonment of the interest also triggers full deductibility of both suspended and current losses under section 469(g) (1). Therefore, the end result is that the taxpayer deducted no loss in year 1, and deducted a $90,000 loss against a $40,000 gain in year 2, netting a $50,000 tax loss that exactly corresponds to his economic loss of $50,000.

In this simplistic example, the same result would occur if the at-risk rules were ignored; the passive activity loss rules would disallow any loss in year 1, and provide for a $50,000 net loss deduction in year 2. The timing of the loss deduction would change if a second passive activity generated $100,000 of income in year 1. In this case, $40,000 of the $90,000 loss would be deductible against this income. In year 2, the $50,000 loss suspended under the at-risk rules would become fully deductible, offsetting the $40,000 phantom gain recognized upon abandonment of the interest and resulting in a $10,000 net loss for the year. (Of course, this variation could not occur if the ability to net passive-activity gains and losses were repealed.) The important lesson to be learned from the example is that both the at-risk and the passive activity loss limitations deal exclusively with the timing of deductions--not with either the fact or the amount of the deduction.

The redundancy problem is not limited to the interplay of sections 465 and 469. Before these limitations are even considered, losses allocated to investors in partnerships - the traditional tax shelter vehicle--are limited under section 704(d) to the tax basis in the investor's partnership interest.[8] Section 752(a) provides that an allocated portion of partnership debt may be included in each partner's basis in his interest. Voluminous temporary regulations under section 752, published on December 30, 1988, provide guidance as to the correct allocation of both recourse and nonrecourse partnership debt to the appropriate partner. The raison d'etre of the allocation is to create sufficient basis against which a partner may deduct his share of partnership losses. If basis is insufficient, the amount of disallowed loss is carried forward into future years until sufficient basis is created.

The section 752 regulations (monstrously complex in their own right) permit partnership losses to be deducted currently against basis created by nonrecourse debt. The theory underlying such permissiveness is that deductions attributable to nonrecourse debt must be paid back penny for penny in the form of future gain recognition upon disposition of the encumbered property. Thus, the partnership regulations reflect a tolerance regarding the timing of loss recognition that is impossible to reconcile with the at-risk rules.

The limitations of sections 704(d), 465, and 469 can be viewed as a series of hurdles that must be cleared before any amount of loss is currently deductible. Each hurdle affects only the timing of the deduction, and yet each hurdle requires the application of a different and intricate set of rules. This succession of hurdles can result in a single loss being divided into three different carryforward amounts, each of which may be triggered at different dates in the future.

History provides a final argument for the repeal of the at-risk rules. Section 465 was first introduced as part of the Tax Reform Act of 1976. One of the principal goals of this major reform legislation was to discourage investment in abusive tax shelters. The House Ways and Means Committee, with Treasury approval, favored the adoption of a limitation on artificial losses (the LAL provision) as the major deterrent against shelters.[9] This provision would have disallowed a current deduction for certain accelerated (artificial) deductions generated by an activity to the extent these deductions exceeded current operating income from the same activity. The LAL provisions would have created a bifurcated tax return in which artificial losses from tax shelters would have been segregated

from salary and investment income. The disallowed losses would have carried forward until such time as the activity generated income or was disposed of.

The Senate Finance Committee would not support the LAL concept, criticizing it for contributing to the "trend toward greater complexity in the tax system" and for failing "to distinguish between actual abuses of tax shelters...and the situations where tax incentives provide important encouragement to economically worthwhile investments."[10] As an alternative to LAL, the Finance Committee proposed the at-risk rules, which were ultimately included in the final version of the act.

The sense of dejâ vu experienced by many tax practitioners upon their first reading of section 469 was attributable to the distinct similarity of the new passive activity loss limitation to the old LAL provision. Ten years after the LAL concept was rejected for its complexity and replaced with the at-risk rules, the more restrictive section 469 was enacted as part of the Tax Reform Act of 1986. In the same piece of legislation, Congress dramatically reduced the incentive to invest in tax-sheltering activities by cutting the highest individual marginal rate to 33 percent (37 percentage points lower than the 1976 rates). From a historical perspective, the logical next step is the repeal of the at-risk rules.

CONCLUSION

The reduction of complexity in the federal tax system should be recognized as a legitimate congressional goal. Simplification of the passive activity rules could be achieved by replacing the netting concept with an activity-specific loss limitation, and by repealing the $25,000 exception for rental real-estate activities. Section 465 should be repealed; the at-risk rules are an anachronism and have no current vitality.

Congress should reexamine the role of the Treasury in promulgating regulations. The recent trend toward regulations that require hundreds of pages to interpret a single Code section (or, as in the case of a Section 469 "activity," a single word) should somehow be reversed. Until the Treasury is willing to curb its own excesses, tax simplification will be impossible to achieve.

ENDNOTES

[1] Eustice, "Tax Complexity and the Tax Practitioner," *California CPA Quarterly*, (September 1976): 10.

[2] Peroni, "A Policy Critique of the Section 469 Passive Loss Rules," 62 *Univ. of S. California Law Review*. 1 (1988): 99.

[3] S. Report No. 99-313, 99th Cong. 2d Sess. 718 (1986).

[4] Wiesner and Milby, "The ABCs of Passive Activity Building Blocks," *J. of Accountancy* (October 1989): 50.

[5] Cuff, "Defining 'Activity' Under the Passive Loss Temp. Regs.," *The J. of Taxation* (August 1989): 75.

[6] This example is derived from Lipton, "PALS at Three: What We Know, What We Don't Know and What Went Wrong," *TAXES--The Tax Magazine* (November 1989): 724.

[7] Supra, note 3, at 739.

[8] Section 1366(d) applies a similar basis limitation to losses allocated to shareholders in S corporations.

[9] Posin, "Tax Shelters: How They Work and the Changes Wrought by the 1976 Act," *Review of Taxation of Individuals* (Summer 1977): 195.

[10] S. Report No. 94-938, 94th Cong. 2d Sess. 39 (1976).

COMMENT ON "AT-RISK AND PASSIVE ACTIVITY LIMITATIONS: SHOULD COMPLEXITY BE REDUCED?"

STEFAN F. TUCKER*

Good morning. I'm coming to you from a different perspective. I'm coming from the perspective of a practitioner. Let me tell you, first and foremost, that I potentially have a conflict in that my clients are entrepreneurs. They're primarily in the real-estate industry. I also am tax counsel to the National Realty Committee, and as such, I have testified in front of the IRS on both sets of its regulations under the passive activity limitations. So what you're going to hear is in part attributable to my kind of practice and what I do.

In addition, I was the final reviewer on the ABA Tax Section task force on passive activity limitations. So those comments, in part, reflect what I think.

Now, there is an advantage and there is a disadvantage to being the last speaker on the panel. The disadvantage is that you stand the risk of being redundant. The advantage is that you can summarize and comment upon what other people have said. Since I have enough to say that I don't think will be redundant, I'm going to treat this as being an advantage.

The first thing I'd like to comment upon is Sally's note that there are still nonrecourse loans above the Red River. One, I'm not so sure that's true, but two, it reminds me of a very simple story of how you can tell the difference today between a Houston developer and pigeon. The difference is that the pigeon can still make deposits on a Mercedes.

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It was promised that I was going to give you a graphic example of what all this has meant to date. What it has meant is what you see over on the far left side; those two red volumes are 1,517 pages--written by an extremely intelligent person, who's intelligent enough no longer to practice in that particular area on one--Code section, 469. That is the explanation of the passive activity limitations under the regulations and the Code to date--1,517 pages.

The three notebooks beside it contain the first set of regulations under section 752 in response to section 79 of the 1984 Tax Reform Act, and in the second and third, the two sets of regulations under section 469, the first set of which, containing 271 pages, as you'll recall, dealt only with material participation and the ability to recharacterize what otherwise might have been passive income into nonpassive income. The second set, containing 195 pages, deals with one word, the word "activity," and the technical corrections to everything they messed up when they issued the first set of regulations on material participation and recharacterization. The third set, we anticipate, will be on self-charged interest and technical corrections to clear up the two sets of problems, one still resulting from the first set and the second set, and the second resulting from the technical corrections done in the second set to the first set, which needs further technical corrections.

Now, I've been in tax practice long enough, but I thought technical corrections were done by Congress. We now have the IRS issuing its own technical corrections of its own proposed and temporary regulations. This is a problem for those of us who are, in fact, practitioners.

Now, will that set of regulations exist and last forever? Will it be, as Sally said, that we ought to keep 469 and eliminate 465? Or, as Stan said, maybe keep them both but clarify?

I would like to read to you a poem written over a hundred years ago by a man named Shelley that was my favorite poem in high school, to think through, if we may, as to what will last and what will not last over a period of time. It is titled "Ozymandias of Egypt."

> I met a traveller from an antique land
> Who said: Two vast and trunkless legs of stone
> Stand in the desert. Near them on the sand,
> Half sunk, a shatter'd visage lies, whose frown
> And wrinkled lip and sneer of cold commend
> Tell that its sculptor well those passions read
> Which yet survive, stamp'd on these lifeless things,
> The hand that mock'd them and the heart that fed;
> And on the pedestal these words appear:
> 'My name is Ozymandias, king of kings:
> Look on my works, ye mighty and despair!
> Nothing beside remains.' Round the decay
> Of that colossal wreck, boundless and bare,
> The lone and level sands stretch far away.

And that's what I think about the 469 regulation.

Now, let me go on. Herb Lerner rightly said that a number of lawyers and accountants are leaving the tax practice because of the complexity of the tax law. You know, it's interesting. We heard that when the 1976 Reform Act came and people said they ought to get out of estate planning. For an entrepreneurial practice like ours, estate planning is an integral part of everything we do. We have gone from one estate planner in the past five years to five estate planners. We don't think everybody is getting out of estate planning.

We don't think everybody is going to get out of tax. What we are worried about, what Herb implied, and I'm hearing more and more is that we're going to end with everybody in the tax law being like Raymond in *Rain Man*. Remember Raymond? He was an autistic savant. He knew everything there was about numbers but nothing else about the rest of the world. We're going to end up with all our younger tax lawyers knowing everything there is to know about 469 or knowing everything there is to know about 752. And yet when we go down the declension, it's not just 469. That's the bottom of the declension. We still have to go through basis and adjusted basis and 752 and 704(b) and 465 and at-risk, and then we get to 469. And yet people aren't learning that. They're learning what's 469. We have 466 pages of regulations to read, but we forget that's only one small part.

You know, I teach federal taxation of real estate transactions, and people say, "How can you do this? 469 permeates everything." No, it doesn't. It doesn't permeate what's the choice of entity you're going to use. It doesn't permeate what's the basis of property, nor does it permeate like-kind exchange, involuntary conversions, and estate planning as such. There's a lot to do and a lot to think about that we're losing sight of, and that we're causing particularly our younger people to lose sight of.

The basis for 469, if I could take you back, was in the blue book from the Joint Committee. Congress concluded that it had become increasingly clear that taxpayers were losing faith in the federal income tax system. This loss of confidence resulted in large part from the interaction of two of the system's principal features: first, its high marginal rates; and second, as a consequence thereof, the opportunities it provided for taxpayers to offset income from one source with tax shelter deductions and credits for another. That was probably what started everything. Yet the primary source, the high tax rates, is gone. And we have a number of other provisions that deal with tax shelters.

So let me start by saying that first, unlike Sally, I don't care if you repeal 465 or not. I thought that it applied to abusive tax shelters. From the perspective of those of us who are practitioners in the day-to-day real world of real estate, 465 is okay if only you clarify two things. One is: It says that except as provided in the regulations, no person can have any liability with respect to the loan. But what if you took, subject to the loan from somebody who is not in your direct chain of ownership at all? Why shouldn't that be outside, just as under 752 "subject to" was nonrecourse, so long as it wasn't a partner who was liable directly or indirectly?

Secondly, the real problem is the fact that section 465 looks at commercially reasonable financing, and it says, for some reason in the legislative history, that kicker interest is, per se, not commercially reasonable. And yet every client today who is doing real-estate transactions is entering into transactions that result in kickers being paid to the lenders. Oh, sure, maybe it's a partnership interest, but is that not a kicker with respect to the loan, potentially? It's very hard to tell if we're dealing with substance over form directly or indirectly.

So I'll live with 465. I think it needs some clarification, and that clarification needs to be statutory and legislative, rather than regulatory. But I'll live with it.

But 469 we can't live with. We simply cannot live with 469. We can live with it as a Code section. We can live with it with a fairly simple straightforward set of regulations to understand, even if that means we looked at the facts and circumstances and we put the taxpayers to the test of standing up under court scrutiny and under audit scrutiny--because, unlike what you read and what you hear, ladies and gentlemen, 469 is a trap for the wary, not the unwary, quite clearly.

How would you like to have a client come into your office and say, "Here is my set of facts. Is this passive income or is it active income or is it investment income?" You respond at your hourly rate (which I'm sure for a lot of you is more than my hourly rate), "I don't know. I read the regulations. I know there are twenty-one building blocks before I find out whether or not you have an activity." Not one, not two, not three, but twenty-one building blocks we have. Undertaking? I thought an undertaking was something when you buried somebody. We have undertaking, all right. We have activities. We have enterprises. We have entities. We have operations. Yes, doctors give operations and undertake their mistakes. Okay? We have to live with them day in and day out, and with potential retroactive changes that result in penalties being attributed to our clients.

We have real problems unless the 469 regulations are, in fact, withdrawn and reissued as simple and straightforward. Now, I realize that that's going to bother some people who have written extensive books, but look at the sale of the supplements. It does not adversely impact them.

Everything you do in the passive activity area results in an unexpected surprise. The only way I could really make you understand how unexpected is to share with you a very short story. You have to imagine with me that both Stan and Ray have died and gone to heaven at exactly the same moment. And Stan gets up to the gate first, and St. Peter says, "Welcome. We're really glad to have you here. We don't very often get tax lawyers, but we're thrilled to have you here. And I have a reward because you've made it to heaven."

St. Peter goes over and opens a door and out walks this scrawly-haired, toothless hag, and Stan says, "This is my reward for getting to heaven." And St. Peter says, "Do you remember when you were four years old and you slugged the little girl next door?" And Stan thinks back, and he says, "Yes." St. Peter says, "Remember when you were five years

old and you stole a dollar from your father's loose change?" And Stan thinks back, and he says, "Yes." And St. Peter says, "Remember when you were six and you were walking to school and you tripped the little boy?" Stan says, "Thank you. I'll take my reward. I'll leave."

Away walks Stan. Ray comes to the gate. St. Peter says, "Welcome," and immediately goes over and opens the same door, and there's Bo Derek. And Ray is really literally in heaven. Just then, St. Peter turns to Bo Derek and says, "Remember when you were four years old..." That's 469 of the regulations.

Let me give you an example. Your client builds a building. It's up for twelve months. They're in the process of renting the building. They've gotten it 78 percent rented, 69 percent occupied. That's better than anything in Tulsa, Oklahoma City, or Houston. And somebody comes along to buy the property. Twelve months later, they sell the property. They come in to you and say, "I have all these passive losses from this property. I'm going to take all of this gain I made on the property." It's going to be passive income. I'm going to wipe out all of my passive losses from the property, and in addition, I'll be able to wipe out other passive losses during the year of sale."

No, not true. It's recharacterized. If you don't have the building completed, not substantially completed, not mostly completed, but completed--now, "completed" implies 100 percent occupied, 100 percent shell and 100 percent tenant improvements in there--then you have a recharacterization rule. That, by the way, was a liberalization from what was previously a twenty-four month holding period. But, as we understand, completion can go for thirty-four years, not twenty-four months.

The second one is holding land for future construction. I hold land for future construction of an office building. Now I'm going to put up the office building. What was my interest on the mortgage while I was holding the land? Was it passive loss that I can apply against the income from the building? Was it investment loss? No. It's a trade or business. Holding for future use without having determined the future use is a separate activity and, therefore, can be treated as a trade or business--strange, to say the least.

Thirdly, imagine you have four projects, one in Baltimore County, one in Fairfax County in Northern Virginia, one in Wilmington, Delaware, and one in Charlotte, North Carolina. All are operated out of one office in terms of receipts and expenditures, but all four locations are separate, and they're all separate home-building enterprises. And, in fact, they're in separate corporations to protect against liability.

The IRS says: "The fact that you put those projects in separate corporations to protect against liability so that if the Wilmington project goes under, Charlotte, North Carolina, is still protected, doesn't mean anything. Those are four undertakings. But because of common control, they're one activity. Therefore, you look at it as a whole, w-h-o-l-e, not as separate activities for your purposes." Strange. Unexpected surprises when you read the regulations.

Let me just note two other things and show you further the kinds of things that we're concerned about. One, you expected complexity when you dealt with consolidated returns or foreign activities with multinationals. You even expected it with widely held C corporations in many respects. But the parties that are dealing with those are sophisticated clients, knowing they need sophisticated accountants and attorneys willing to pay for the same.

Your day-to-day entrepreneurial client can't afford to be faced with the same complexity that results in a 1,517-page book on one Code section, and they're going to have to pay to deal with it. What you're going to run into, what our clients fear is going to happen--not to themselves but others--is you're going to be back to the audit lottery. And the reason you're going to be back to the audit lottery is that the clients are saying: "We'd rather pay later than pay you all this money right now to tell us you don't know the answer." And, moreover, what you think is the answer today can, by regulation, retroactively be changed tomorrow so that whatever we did was wrong in the first place.

That in and of itself cries out for the repeal of 469 in one way or the other--either the section itself or the regulations with simplification. Now, why would I have the nerve to say, "Repeal 469"? You don't need it. You don't need 469. With the elimination of the ITC, with ACRS going to twenty-seven-and-a-half and thirty-one-and-a-half years, with the fact that the S&Ls and banks are now regulated as to each and every loan they make, so they're not making any more FWFs--everybody else uses acronyms, so do we: free-wheeling financings--since you have that, since you have the alternative minimum tax applied, since you have the uniform capitalization rules under section 263(a), you don't need 469. We'll leave you 465 if you clarify it. But none of us needs 469. Thank you.

EMPLOYEE BENEFITS: STATUTORY SIMPLIFICATION

DAVID J. KAUTTER*

THE CURRENT STATE OF PRACTICE

As much as any area of the Internal Revenue Code, the rules governing the taxation of employee benefits have become increasingly intricate and complex over the past fifteen years. This area of the law is now at a point where much of the advice being rendered on the tax aspects of employee benefits is being rendered by specialists who work exclusively in the employee benefits area and who are often unsure of the advice they are rendering. Some employee benefit advisers believe that even focusing exclusively on the compensation area is too overwhelming an assignment. These advisers have subdivided their employee-benefits tax groups into three subgroups which parallel the structure of the Internal Revenue Code: qualified plans, fringe benefits, and nonqualified arrangements. Individuals are expected to devote their careers to mastering the rules in one of these areas.

Clearly the most complicated of the three areas mentioned in the preceding paragraph is the qualified retirement plan area. The fringe benefit rules, following the repeal of section 89, are a distant second. The rules governing nonqualified arrangements (e.g., incentive and nonqualified stock options, property transfers under section 83) are the least complex and do not seem to be creating much confusion at the moment. With the fringe benefit rules and the rules for nonqualified arrangements not being very complex, or at least not generating much uncertainty, this paper focuses primarily on simplification of the qualified retirement plan tax rules and secondarily on rules governing the taxation of the fringe benefits.

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The question dealt with in this paper is whether the rules governing the taxation of employee benefits must be as complicated, intricate, and detailed as they now are or whether substantial simplification can be achieved while retaining most of the underlying policy objectives of current law. In other words, should someone have to devote an entire career to one of these three sub-areas in order to be assured of the advice they are rendering?

CAUSES OF COMPLEXITY

There are two primary causes of the current complexity in the employee benefits tax rules. The first can be characterized as "incremental overload," the relentless layering of one set of changes upon another without the integration of these sets of changes into a comprehensive statutory scheme. Part of the reason for the incremental overload is the budget deficit and the yearly pressure on Congress to raise revenues. In order to avoid outright tax rate increases, Congress chooses to close loopholes which results in fine-tuning of laws that increases complexity. Because of the tremendous wealth invested in private pension funds--over $2 trillion--it is likely that Congress will continue to seek revenues from this area.

The second is the attempt by policy makers to write rules that are so comprehensive and so specific that it is impossible for a taxpayer, even in the most remote circumstance, to contravene statutory intent in the slightest. It should be noted that not all of the complexity attributable to this second cause emanates from Congress. The Executive Branch in its efforts to fine tune statutory language and fully implement the intent of Congress has also contributed to the increasing complexity. Exhaustive regulations which are virtually incapable of being fully understood, but with which taxpayers are expected to comply immediately, have become more common. For example, regulations implementing the rules of §401(a)(26), dealing with minimum participation in qualified plans, are so broad in scope and intricate in detail that their full impact will take years of implementation to comprehend. Yet taxpayers are expected to understand and implement the rules almost immediately after their issuance. The current approach can be likened to that of a fisherman who weaves his nets so tightly to prevent even the smallest fish from slipping through the net that he is pulled overboard when the net is tossed into the water.

The consequences of these two forces are complexity, confusion, intentional and unintentional noncompliance, and increasing costs to employers to provide the same level of benefits to their employees.

We have reached this point gradually. In the early 1920s, the tax incentives for pension plans in which the employer contribution is deductible as a current expense and the employee does not recognize income until distributions are received were relatively straightforward and created an environment for the growth of these types of plans. During World War II and the Korean War, wage-price stabilization restricted increases in direct compensation so that profits were directed to pensions and welfare benefits but the rules remained relatively straightforward.

Following that era, the growth of pensions and fringe benefits continued as unions began to negotiate new and improved benefits, and increased competition required non-union employers to provide benefits. By the early 1960s, employee benefits were widespread within American corporations, but there was growing concern as to the security of these benefits. President Kennedy appointed a pension commission, which recommended measures for the protection of benefits and several unions (e.g., auto workers and steel workers) actively pushed for pension protection legislation. While this legislation was resisted initially by employers, events such as the NBC White Paper and Sunday supplements publicized horror stories, which caused popular opinion to move toward support for additional federal legislation and preemption.

Protection of workers was the original goal of the labor committees at this point in time, and they proposed the basic participation, vesting, funding, benefit accrual, anti-cutback, pension insurance, and fiduciary standards that we have today. At that time, the tax committees were also concerned about the protection of employee benefits, and they proposed rules similar to those being considered by the labor committees.

The Employee Retirement Income Security Act of 1974 (ERISA), which was signed into law on September 2, 1974 by President Ford, is a good example of how our laws in the employee benefits area <u>used</u> to be made. In that case, a bill was introduced for discussion purposes, and hearings were held over several years and around the country. The labor subcommittees involved made transcripts of hearings available and met to debate, amend, and mark up the bill. The full labor committees then marked up the bill. Then a report was filed by the full committee detailing the need and history with an opportunity for minority and supplemental views. In addition, because the pension law had tax implications, these proposals were subjected to similar scrutiny by both tax committees. Following that, the bill was debated on the House and Senate floors. Finally, the House and Senate versions went to the Conference Committee to reconcile differences. The ERISA conference then extended over several months time. Although there has been criticism of ERISA, especially its duplicative and overlapping provisions, neither the thoroughness or completeness of the process, nor the comprehensive integrated nature of the statute can be questioned.

The 1980s brought new dimensions to the process by which employee benefits laws are written because of the search for revenue and the changing legislative process. In this decade, the process has moved more toward tax-writing committees and away from labor committees. Revenue raising has become the primary goal and worker protection, while still considered, has taken a back seat. In short, recent employee benefits legislation usually looks first at the federal revenue effects of a given concept and later, if at all, at the worker protection aspects for proposed legislation. This also points up the fact that employee benefit issues, and many others, are now addressed in omnibus bills or mega-bills. Examples of these are budget reconciliation bills and continuing resolutions. Often, there are no hearings held on specific proposals included in this type of legislation. The reconciliation bills, or at least part of them, are often drafted after committee consideration. In some cases the final bills will be as long as 1500 to 2000 pages. Many significant provisions become lost and buried in the volume, and the bills are rushed to the floor with little time

allowed for comment by the public, floor debate of many provisions, or any real opportunity to alter or amend their content.

At the same time, the concept of the three-legged stool of private savings, Social Security benefits, and employer-sponsored pensions appears to have been altered dramatically. Many experts predict a crisis in the Social Security System following the retirement of the baby boom generation from approximately the year 2025. A recent survey of 491 pension actuaries found that 72% of those surveyed believe that no more than 50% of the baby boomers, who will reach age 65 between the years 2010 and 2028, will be economically able to retire by age 65. (Edelman Public Relations, *Forecast 2000*, November 7, 1989). The private savings leg of the stool is suspect because few employees seem to have the ability or the incentive to save in our current system. The weakening of these two legs puts significant additional weight upon the third leg of employer-sponsored pensions. This highlights the necessity of dealing with the current causes of complexity. Failure to do so may well result in a substantially weakened private pension system.

EMPLOYEE BENEFITS AND SIMPLICITY

In the employee benefits area, as in other areas, a balance must be struck between simplicity and equity. Equity usually comes in the form of nondiscrimination rules in the employee benefits area. The size, shape, and scope of "undue complexity" are elusive and relative concepts, but it is clear that, in reducing the complexity implicit in the rules governing the taxation of employee benefits, some equity will be lost. The goal is to find the right balance between inhibiting as much discrimination as possible while utilizing rules that can be broadly understood and implemented. The difficulty in recommending changes to reduce the complexity of the existing tax law rests in the fact that all provisions currently in the Internal Revenue Code can be justified from a policy point of view.

This paper attempts to identify areas of the law where substantial simplification can be achieved while retaining the underlying legislative policy behind a provision. In some cases, reduction of complexity does not involve a reexamination of the tax policy underlying the current rules. In others, a tax policy reexamination is required and may require accepting, as a society, some incremental discrimination above that which is currently allowed. It may also involve accepting less flexibility on the part of taxpayers in the design and operation of tax-favored employee benefit arrangements. This may not be easy for some to accept. The primary purpose of this paper, however, is not to dwell on the political acceptability of various proposals, but to focus on what can be done to reduce the complexity of the existing tax rules while retaining as much as possible of the underlying legislative intent behind the current rules.

Similarly, the proposals in this paper do not involve a fundamental reexamination of our nation's retirement policies. Although it is often impossible to separate the underlying policy from the complexity, when the two conflict, this paper attempts to recommend changes driven by the goal of reducing complexity which retain as much of the current underlying policy as possible.

QUALIFIED PLANS

Introduction

This paper adopts the premise that qualified retirement plans should be designed to provide income to individuals upon their retirement. Adopting this premise means accepting a certain amount of complication as inherent in this area of the tax law. Specifically, the process of setting aside funds during an individual's working career to provide replacement wages at retirement is inherently complicated.

The basic concepts currently in force in the qualified retirement plan area appear to be sound, and this paper does not propose eliminating any of the following concepts: (1) plan and trust, (2) participation requirements, (3) vesting requirements, (4) benefit accrual requirements, and (5) distribution rules. The approach of this paper is to take each aspect of these concepts and examine it to determine whether the additional equity brought to the Internal Revenue Code is justified by the complexity implicit in the existing rule. The goal has not been to introduce a new order into the qualified retirement planning area, but to streamline the existing order in the belief that the basic concepts are sound and have worked well. Similarly, the goal is to set forth proposals that will reduce complexity and that can be implemented in the near-term without a massive reexamination of our nation's retirement policies.

General Proposals

Proposal: Conform the terminology used in the Internal Revenue Code (Code) to describe qualified retirement plans with a single set of terms--Defined Contribution Plans and Defined Benefit Plans.

<u>Current Law</u>

The Code currently uses two sets of terms to describe qualified retirement plans: pre-ERISA terms and ERISA terms. The pre-ERISA terms are profit sharing plans, pension plans, and stock bonus plans. The ERISA terms are defined contribution plans and defined benefit plans. Every plan has a pre-ERISA and an ERISA name, and a taxpayer must know both names for each plan in order to accurately apply the rules in the Code to a particular plan. For example, most of the ERISA qualification sections, e.g., §415, refer to defined contribution and defined benefit plans. Many of the pre-ERISA Code sections, e.g., §§402 and 404, refer to pension plans, stock bonus plans, and profit-sharing plans.

In general, there are three types of defined contribution plans: profit-sharing plans, stock bonus plans, and money purchase pension plans. TRA 86, however, eliminated the requirement that contributions to a profit-sharing plan must be made from an employer's current or accumulated profits.[1] This eliminates a major difference between profit-sharing plans and other defined contribution plans. The remaining distinctions include the

requirement that a money purchase pension plan have fixed annual contributions while a profit-sharing plan may have fixed or discretionary annual contributions. A second distinction exists with respect to when distributions may be made from each of these plans. A third distinction is that the limitation for deductible contributions is generally 15% of compensation for a profit-sharing or stock bonus plan and 25% of compensation for a money purchase pension plan.

Finally, the primary distinguishing characteristic of a stock bonus plan is that the participants of a stock bonus plan have a right to demand their distribution in employer securities while participants in profit-sharing and money purchase pension plans are not required to have that right.[2]

Proposal and Rationale

The Code should be structured around the ERISA terms--defined contribution and defined benefit plans. The elimination of the profits requirement for a profit-sharing plan leaves very little distinction between the types of defined contribution plans from a definitional point of view. It is difficult to see what policy purpose is now served by using two terms in the Code to describe each plan. While distinctions would continue to be permitted between the types of defined contribution plans--for example, the employer could still establish a plan calling for either fixed or discretionary contributions or one that mandates distributions in employer stock--those distinctions would be meaningless in applying the qualification, deduction, and distribution rules.

Reduction of Complexity Achieved

This proposal would allow taxpayers to use one set of terms to apply the qualification, deduction and distribution rules. This proposal would also conform the terminology of the Code to the terminology of Title I of ERISA (the rules administered by the Department of Labor) facilitating the ability of taxpayers to understand both the non-tax and tax consequences of their actions.

Specifically, §§401(a)(27) and 401(a)(23) would be repealed. The changes required to §404 will be discussed later in the paper.

Proposal: Segregate leveraged ESOPs from the qualified requirements and treat them as a separate financing vehicle.

Current Law

Various leveraged ESOP requirements can be found throughout the qualification and other sections of the Code that deal with qualified retirement plans. For example, §§401(a), 404,409,415, and 4975 all deal with leveraged ESOPs as well as with other qualified plans.

Proposal and Rationale

The leveraged ESOP requirements should be removed from the qualified plan rules and collected in a separate subchapter of the Code. The rationale is that, in substance, leveraged ESOPs have tended to be a financing vehicle rather than a retirement vehicle, although they have attributes of both. There are a number of requirements that are unique to leveraged ESOPs which appear throughout the qualified plan rules. Unless someone is intimately familiar with all these rules and their location in the Code, the chance of their overlooking a particular requirement is unnecessarily high. Isolating these rules from the qualified plan rules would eliminate a source of complexity in the qualified plan rules, recognize the unique nature of leveraged ESOPs, and collect all the related rules in one subchapter.

It is not being proposed that the leveraged ESOP rules be repealed. What is being proposed is that these requirements be collected separately in their own subchapter so that someone need not be an ESOP expert in order to answer a question with respect to them.

Reduction of Complexity Achieved

When dealing with qualified retirement plans, the following sections would no longer need to be considered: §§401(a)(28), 409, 404(a)(9), 404(k), 415(c)(6), 4975(e)(7), and 4975(d)(3). These sections would be collected in a separate subchapter of the Code.

Proposal: Eliminate, to the extent possible, the remaining statutory distinctions between self-employed individuals and common-law employees.

Current Law:

Beginning with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), distinctions between the qualified plan rules applicable to self-employed individuals and those applicable to common law employees have slowly been eliminated. This has significantly simplified the law. However, several distinctions remain between the rules applicable to plans covering owner-employees (certain self-employed individuals) and other participants. Under current law, owner-employees are subject to unique aggregation rules (§401(d)) and cannot obtain loans from qualified plans under the same terms as participants.[3]

Other areas which involve a distinction between owner-employees or self-employed individuals and other participants are §§401(c)(1), 401(c)(2)(A), 403(a)(3), 404(a)(8), 404(e), 408(k)(7)(A), 415(bX3), 415(c)(3)(B), 416(i)(3), and 72(m)(6). Still other sections limit contributions to earned income (§404(a)(8)(C)); preclude the use contributions made to a qualified plan on behalf of a self-employed individual to purchase life, accident, health or other insurance (§§404(a)(8)(C) and (e)); prohibit deductible contributions exceeding earned income (§404(a)(8)(C)); permit disability of a self-employed person to qualify as a triggering event for lump-sum distribution treatment (§§402(e)(4)(A)(iv) and 72(m)(6)); discuss the rules of annuity taxation (§403(a)(3)); and define compensation for purposes of the annual additions limitations (§§415(b)(3) and 415(c)(3)(B)) or the deduction limitations (§401(c)(2)(A)(v)).

Proposal and Rationale

Those distinctions that remain after TEFRA can be divided into two groups: (1) those designed to treat certain self-employed individuals differently from other plan participants (the owner-employee rules), and (2) those necessary to make sure there is equivalent treatment between self-employed individuals and other participants. Eliminating the first set of distinctions would simplify the law without sacrificing any significant policy goals. It is proposed that the flush language in §4975(d) that prohibits loans from qualified plans to participants who are owner-employees be repealed. The special aggregation rules of §401(d) should also be repealed.

These changes would eliminate an existing trap for the unwary as well as simplify the Code. Retention of the second set of distinctions will ensure equivalent treatment between self-employed individuals and other participants.

Reduction of Complexity Achieved

The flush language in §4975(d) would be repealed. Also repealed would be §§401(c)(3), 401(c)(5), 401(d), and 401(a)(10)(A). Section 416(i)(3) would be repealed as part of an overall repeal of the top-heavy rules discussed below.

Proposal: Simplify the definition of highly compensated employee under §414(q)

Current Law

Under current law, a highly compensated employee is defined as any employee who during the current or preceding year--

a. Was a 5% owner;

b. Received compensation from the employer in excess of $75,000;

c. Received compensation from the employer in excess of $50,000 and was in the top-paid group of employees for such year; or

d. Was an officer and received compensation greater than 50% of the amount in effect under §415(b)(1)(A) for such year.[4]

A participant who is described in b, c, or d above (for the current plan year only), shall not be a highly compensated employee unless he is among the 100 employees paid the greatest compensation during the year.

Proposal and Rationale

One of the key concepts that permeates the entire qualified plan area is the prevention of discrimination in favor of highly compensated employees. Under TRA 86, the Code for the first time specifically set forth rules for determining who is in this group.

However, the definition is difficult to work with, and a clear, simple definition would reduce complexity. It is recommended that the Code define the highly compensated group as: (1) 5% owners with attribution (as defined in §318 of the Code), (2) those earning compensation in excess of $75,000 (indexed for inflation), and (3) the three highest-paid officers, if their compensation is less than the indexed standard. In addition, the highly compensated group would be determined on the basis of the preceding plan or employer year, not the current and preceding years as under current law.

Reduction of Complexity Achieved

The proposal would simplify plan administration and testing because the highly compensated group would be easy to identify.

Proposal: Provide a uniform definition of compensation for purposes of the employee benefit rules.

Current Law

Code §414(s), 414(q), 415 and 401(a)(17) all provide different definitions of "compensation." Because of the significance of this concept throughout the employee benefits sections of the Code, it is important to have a simple, uniform definition.

Proposal and Rationale

A uniform definition of compensation should be established to simplify the task of plan sponsors and administrators. The uniform definition should be tied to taxable compensation with elective contributions under §125, 401(k), 408(k), 403(b), 457, and 501(c)(18) added back at the employer's election on a uniform and nondiscriminatory basis. For example, a calendar-year plan would simply use W-2 compensation including the specified elective contributions if the employer elects. A fiscal year plan could either determine taxable compensation on the fiscal-year basis or use W-2 compensation for the calendar year which ends in the fiscal-year. This definition should be used for all purposes of the employee benefit rules.[5]

Reduction of Complexity Achieved

A uniform, simplified standard for compensation which would reduce complexity in plan design and administration, and eliminate the existing trap for the unwary.

Plan Qualification Proposals

Proposal: Repeal the top-heavy rules.

Current Law

The top-heavy provisions, enacted as part of TEFRA, provide for accelerated vesting, minimum benefit accrual, and a limit of $200,000 on the amount of compensation that can be taken into account under a qualified plan. Congress concluded that in the case of plans under which more than 60% of the benefits are focused on key employees, special rules were needed to assure that the rank-and-file employees would receive the benefits that the tax incentives were provided to encourage.[6]

TRA 86 significantly lessened the differences between top-heavy and non-top-heavy plans by capping the amount of compensation taken into account at $200,000 for all qualified plans and also accelerating vesting schedules for all qualified plans.[7]

The allowable vesting schedules are:

	Cliff Vesting		Graduated Vesting	
Years of Service	Top-Heavy	Other	Top-Heavy	Other
1	0	0	0	0
2	0	0	20	0
3	100	0	40	20
4		0	60	40
5		100	80	60
6			100	80
7				100

A plan that is top-heavy also must provide a minimum defined benefit for non-key employees equal to 2% multiplied by the number of years of service with the employer (up to a maximum of 20%) times the individuals' compensation. A non-key participant's compensation is determined over the period of consecutive years, not in excess of five, that the participant's compensation was the highest.[8] In a defined contribution plan, a minimum defined contribution amount of 3% of compensation, or the amount of the actual percentage contribution made on behalf of key employees, if less, must be made on behalf of non-key employees.[9] Social Security contributions or other legally required contributions cannot be taken into account for purposes of these benefit requirements.[10]

Non-top-heavy plans are not required to provide minimum benefit levels; however, contributions may not be skewed in favor of the highly compensated (§401(a)(4)), and the Social Security integration rules now require minimum benefit levels for integrated plans.

Proposal and Rationale

The special rules of §416 should be repealed. While §416 served a purpose when it was passed, one limitation imposed by §416 ($200,000 cap on compensation) now applies to all plans, and another (faster vesting) is virtually the same for top-heavy and non-top-heavy plans. The other significant difference between top-heavy and non-top-heavy plans involves benefit accrual, and with recent changes in the permitted disparity rules in TRA 86, this difference is significantly less than it was in 1982.

The regulations to be issued under §401(a)(4) could provide further guidance if any perceived gaps exist.

The top-heavy rules also contain their own definition of the employees in whose favor discrimination is prohibited ("key employee"). Following TRA 86, most Code sections affecting discrimination use the term "highly compensated employee." At a minimum, the use of the term "key employee" should be eliminated and the TRA 86 definition of highly compensated employee substituted.

In view of the fact that virtually all plans must include these provisions, and that the incremental benefit of the top-heavy rules has been diminished by subsequent changes in the Code, these provisions could be eliminated with little adverse impact on participants and reduce complexity in the law and plan documents.

Reduction of Complexity Achieved

Repeal of 416 and 401(a)(10)(B) and the yearly testing that is required under the provision.

Proposal: Reconsider §401(a)(26).

Current Law

Section 401(a)(26) provides that each plan, independently, must cover the lesser of 50 employees or 40% of the total employees of an employer (determined on a controlled and aggregated group basis).

Proposal and Rationale

The §401(a)(26) minimum participation rules are aimed at preventing multiple plans covering few employees from discriminating against nonhighly compensated employees. Section 410(b) is also aimed at preventing discrimination against nonhighly compensated employees, but may be applied on a group plan basis if such plans are comparable in accordance with Rev. Rul. 81-202,1981-2 CB 93.

In enacting §401(a)(26), the legislative history indicates Congressional concern that although plans that are aggregated are required to satisfy comparability requirements with respect to the amount of contributions or benefits, such an arrangement may still

discriminate in favor of the prohibited group. Differences in the rates at which benefits are accrued (e.g., presence or absence of past service credit) and the selective use of actuarial assumptions in valuing plan benefits may cause a plan that satisfies the requirement of comparability with respect to the amount of contributions or benefits to favor the highly paid. Similarly, in the case of plans that are comparable with respect to the amount of contributions or benefits, discrimination favoring the highly paid may occur because of disparate funding levels and benefit options that are not taken into account in such a comparability analysis.[11]

Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in funding levels and benefit options, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination standards by small aggregated plans. Thus, Congressional intent may be summarized as desiring to obtain both nondiscrimination and simplicity.[12]

The regulations issued under §401(a)(26), by all standards, are anything but simple.

The Service has stated that it will soon issue a new revenue ruling which will expand upon Rev. Rul. 81-202 and make it more difficult to discriminate using comparability of plans in order to satisfy §410(b). Eliminating one-person plans or highly specialized plans that cover small numbers of employees is appealing in reducing the number of plans maintained by a controlled group and in easing the audit burden of the Internal Revenue Service. However, unless the regulations under §401(a)(26) can be redrafted in a manner that reflects the straightforward manner of the statute, then §401(a)(26) should be repealed.

If the regulations can be properly drafted, the repeal of §401(a)(26) may not be necessary. If the regulations cannot be re-drafted and if §401(a)(26) is repealed, then any perceived problems with comparable plans should be dealt with directly by amending the rules of Rev. Rul. 81-202. Section 410 should adequately cover the objective of preventing plans from being discriminatory against the nonhighly compensated. If any gaps exist, the forthcoming revenue ruling, final §410(b) regulations, or additional pronouncements from the Service could cover them. Alternatively, the percentage tests of §410(b) could be increased above 70% to minimize any abuses. This proposal is one which could result in some incremental discrimination above that allowed by current law, but the reduction in complexity achieved would be substantial.

Reduction of Complexity Achieved

The complexity resulting from §401(a)(26) and the regulations promulgated thereunder would be eliminated.

Proposal: Eliminate the ability to provide medical benefits to retirees from qualified plans.

Current Law

IRC §401(h) allows certain medical benefits to be paid to retirees from qualified retirement plans. Under the statute, a pension or annuity plan may provide for the payment of benefits for sickness, accident, hospitalization, and medical expenses of retired employees and their spouses and dependents, but only if the following six requirements are met:

a. The benefits are subordinate to the retirement benefits provided by the plan;

b. A separate account is established and maintained for these benefits;

c. The employer's contributions to the separate account are reasonable and ascertainable;

d. The corpus or income of the separate account cannot be diverted to any purpose other than providing these benefits;

e. If all liabilities to provide these benefits under the plan are satisfied, any amount remaining must, under the terms of the plan, be returned to the employer; and

f. For each key employee, a separate account is established and maintained for these benefits.

"Subordinate" has been defined in the regulations to mean that at all times the aggregate contributions to provide such medical benefits (and any life insurance protection) does not exceed 25% of the aggregate contributions, other than contributions to fund past service liability.[13]

Proposal and Rationale

Qualified retirement plans should not be allowed to provide medical benefits for retirees. Qualified retirement plans are plans of deferred compensation designed to replace wages upon retirement, not plans designed to replace an employee's entire compensation arrangement. These accounts cause additional complication in plan documents, plan administration, and plan design.

It is not being proposed that employers not be allowed to pre-fund any of their retiree medical liability. Those who wish to pre-fund this obligation could do so on a tax-preferred basis by utilizing a voluntary employee beneficiary association described in §501(c)(9).

Reduction of Complexity Achieved

The elimination of §§401(h) and 415(1) and modification of §404(e).

Proposal: Eliminate 1.401-4(c)(2)(ii) concerning restriction of benefits which may be paid to the 25 highest paid employees.

Current Law

Section 1.401-4(c)(2)(ii) requires that the employer contributions which are used for the benefit of any employee who is among the twenty-five highest paid employees of the employer be restricted if the plan is terminated within ten years of its establishment or the benefit becomes payable within 10 years of the establishment of the plan.

Section 415 limits the amounts which may be paid from a defined benefit plan. After TRA 86, the maximum benefit payable under §415 cannot accrue any faster than ratably over ten years of plan participation.

Proposal and Rationale

Under §415, the benefits which may be paid to an employee are limited to no more than $90,000 (indexed) or 100% of compensation actuarial reduced for early retirement. In addition, §415 now sets forth the requirement that the maximum benefit payable may only be accrued ratably over ten years of plan participation. This prevents a highly compensated employee from receiving a large benefit shortly after a plan has been established. This structure significantly diminishes the possibility of abuse at which §1.401-4(c) is aimed. In addition, this regulation was adopted before ERISA, which introduced the Pension Benefit Guaranty Corporation and minimum funding rules. Both innovations have also helped to prevent the type of abuse which this regulation was originally enacted to prevent. Finally, the new minimum funding rules under the Omnibus Reconciliation Act of 1987 (OBRA) also help to ensure that plan participants and beneficiaries are protected from the type of abuse at which this regulation is aimed.

Due to the diminished possibility of abuse, §1.401-4(c) of the regulations should be revoked. This is a situation where significant reduction in complexity could be achieved by eliminating a largely redundant provision.[14]

Reduction of Complexity Achieved

Treasury regulation §1.401-4(c) would be eliminated and, therefore, plan design would be simplified.

Proposal: Expand §401(b) to set forth rules governing the amendment of qualified plans after plan year end with non-qualification-type amendments.

Current Law

Section 401(b) provides the mechanism for retroactively correcting disqualifying provisions contained in a plan document. There is no statutory or regulatory authority concerning the time limit that can be imposed for making other amendments that do not affect the plan's qualification and that do not retroactively reduce an accrued benefit.

Proposal and Rationale

Section 401(b) should be amended to include guidelines for amending qualified plans in situations where the amendments do not affect plan qualification. This would clearly detail the ability of plan sponsors to amend their plans during and after a particular year, eliminate an area of controversy, and simplify plan administration. This could be done by extending the rules of §401(b) to amendments that do not affect a plan's qualification.

Reduction of Complexity Achieved

Plan administrators and employers will know with certainty how to amend a plan in other than a disqualifying situation, eliminating an area of unnecessary uncertainty.

Proposal: Simplify the distribution of qualified preretirement survivor annuity (QPSA) notices.

Current Law:

Under current law, certain plans must provide each participant, within a certain period, a written explanation with respect to the qualified preretirement survivor annuity option. The period during which the notice must be given is defined in §417(a)(3)(B)(ii)(I) as the period beginning with the first day of the plan year in which the participant attains age thirty-two and ending with the close of the plan year preceding the plan year in which the participant attains age thirty-five.

Proposal and Rationale

The QPSA notice should be required to be provided only to individuals within a reasonable period after they become plan participants. There is little logic in providing this notice only at the current age range, since most employees are sophisticated enough to understand the notice at any age. This provision has simply resulted in an increased compliance burden for plan sponsors without a commensurate return, either in understanding on the part of the participants or in achieving effective disclosure.

Reduction of Complexity Achieved

This would result in the repeal of §417(a)(3)(B)(ii)(I).

Benefit Accrual Proposals

Proposal: Eliminate the actual deferral percentage test in cash or deferred arrangements.

Current Law:

Section 401(k)(3) provides that the amounts deferred by highly compensated employees cannot exceed a multiple of the amounts deferred by nonhighly compensated

employees. Specifically, the actual deferral percentage of the highly compensated employees cannot be either more than 125% of the actual deferral percentage of the nonhighly compensated employees or more than twice the actual deferral percentage of the nonhighly compensated employees with a differential of no more than 2 percentage points.

The Service has issued regulations explaining bow to test employee elective deferrals for discrimination. Employer contributions may in some circumstances be used to help satisfy the actual deferral percentage test. In addition, certain matching contributions can also be used to help satisfy the discrimination tests. If the employer cannot afford, or does not wish, to make employer contributions to help satisfy the test, and the tests have not been met by plan year end, the employer may recharacterize or distribute the excess deferrals. Penalties leading up to plan disqualification are imposed if the excess 401(k) deferrals are not distributed or recharacterized in a timely fashion. The Service has issued notices and regulations explaining when, and to what extent, deferrals may be distributed or recharacterized.

Proposal and Rationale

The actual deferral percentage test of §401(k) was enacted at a time when highly compensated employees could elect to defer up to $30,000 annually under a §401(k) plan. It is aimed at preventing a 401(k) plan from discriminating against lower-compensated employees, and operates to supplant §401(a)(4). The potential for discrimination in a 401(k) plan has been dramatically reduced by the lowering of the elective deferral limitation in TRA 86 to $7,000 (indexed for cost of living). The performance of the actual deferral percentage test is time consuming for a plan of any significant size, and many plan sponsors have not accurately tested on a timely basis.

The §401(k) rules should be amended: (1) to require that all employees with a requisite age and year(s) of service and not in excluded categories under §410(b) be permitted to make deferrals under an employer's 401(k) plan, and (2) the actual deferral percentage test be repealed.[16] The amount eligible for deferral could be reduced, for example to $6,000, further minimizing the possibility of discrimination, and this amount could be indexed for cost-of-living in tandem with the IRA limit of $2,000, which has remained fixed since 1982.

Reduction of Complexity Achieved

Code §401(k)(3), §4979 and the regulations and notices promulgated thereunder would be eliminated. Section 402(g)(1) would be modified to reflect a lower limit and the §402(g)(5) adjustment for cost-of-living would remain in effect.

Proposal: Expand the coverage rules for 401(k) plans to include employees of tax-exempt organizations and eliminate the separate rules in §403(b).

Current Law

A 401(k) plan is not treated as a qualified 401(k) plan if it is part of a plan maintained by any tax-exempt organization or a state or local government or political subdivision thereof. On the other hand, a separate provision (§403(b)) applies only to certain tax-exempt and charitable organizations and allows employees of these organizations to participate in arrangements which involve cash or deferred elections.

Proposal and Rationale

It is difficult to understand why tax-exempt organizations are prevented from making salary deferrals available under §401(k) and yet can make salary deferral elections available in an even more liberal fashion under §403(b).

In addition, there appears to be no compelling policy justification for requiring employees of tax-exempt organizations to participate in annuity contracts or custodial accounts rather than in the investments available to employees of non-tax-exempt organizations. Therefore, the complete elimination of §403(h) can be accomplished. In an age where self-directed accounts are very commonly available through any of the large, national brokerage firms or other financial institutions, individual accounts are relatively easy to establish, not very costly, and much more convenient for employees of tax-exempt organizations than when §403(b) was enacted.

In order to simplify the Code, tax-exempt organization employees should be treated the same as all other employees for salary deferral purposes. Thus, employees of both types of organizations should participate in identical plans, have the same salary deferral amount as a ceiling, and have the same plan investment alternatives available to them.

Reduction of Complexity Achieved

This would have the effect of repealing §403(h) and extending the 401(k) plan rules to employees of tax-exempt organizations.

Proposal: Eliminate the ability of employees to make after-tax contributions to qualified retirement plans.

Current Law

If a qualified retirement plan permits, employees may make voluntary after-tax contributions to the plan. For plan years beginning after 1986, these voluntary after-tax contributions count on a dollar-for-dollar basis against the limits of §415(c). Additionally, a qualified plan that allows after-tax employee contributions is subject to a nondiscrimination test under §401(m) that is similar to the nondiscrimination test in §401(k). The non-discrimination tests of §401(m) were enacted because of the fear that

voluntary after-tax employee contributions are utilized primarily as a tax-deferred savings vehicle for the highly compensated.

Proposal and Rationale

The ability of a qualified plan to accept voluntary after-tax employee contributions should be eliminated and §401(m) should be repealed. The rationale is one that is motivated solely by a desire for reducing complexity.

Allowing after-tax employee contributions to be made to qualified plans now requires plan administrators to separately account for these amounts annually to ensure that the tests of §401(m) are met. These amounts must be separately identified when distributed to participants and involve a separate subset of rules in the distribution area to determine what is taxable to a participant and what is a recovery of the participant's basis. These rules are complicated from both a technical and a plan administration perspective.

The elimination of voluntary after-tax contributions would not only reduce complexity in the statute but would also reduce complexity in the administration of qualified plans. Adoption of this proposal would not leave employees without tax-deferred investments because Individual Retirement Accounts (IRAs) on a nondeductible basis under §408(o) (which were not available until tax years beginning after 1986), tax-deferred annuities, and other investment products, such as municipal bonds, are offered in this category. Further, the existence and rapid acceptance nationally of pre-tax deferrals in 401(k) made the after-tax contribution a less attractive alternative for employees.

If Congress decides that employees should be allowed to fund larger tax deferred savings accounts for their retirement by using after-tax contributions, the existing rules for IRA after-tax contributions could be amended to increase the allowable level of contribution.

With §401(m) repealed, matching contributions would be subject to the nondiscrimination principles in §401(a)(4). The statute could provide that if matching contributions are available at the same rate for all employees, the matching contributions would be deemed to be nondiscriminatory.

Reduction of Complexity Achieved

The following Code sections governing plan qualification can be repealed if voluntary after-tax employee contributions are eliminated: §401(a)(19), 401(m), 411(c), and 411(d)(5). In addition to reducing complexity in the qualification area, the elimination of voluntary after-tax employee contributions will reduce complexity in the area of distribution planning and the taxation of distributions. For example, if voluntary after-tax employee contributions are repealed, the portion of §72 which deals with the recovery of the employee's basis could be eliminated; §402(a)(5)(B) could be repealed; and the second sentence of §402(a)(1) could be repealed. A transitional rule could be provided to facilitate the distribution of existing voluntary after-tax contributions from qualified plans. For example, participants could be allowed to transfer these amounts, with or without earnings, to an IRA.

Proposal: Eliminate the permitted disparity rules (Social Security integration rules) or return to pre-87 integration.

<u>Current Law</u>

TRA 86 substantially amended the Social Security integration rules. For example, in an integrated qualified plan, it is no longer possible to deny a participant a benefit accrual or contribution just because the plan is integrated with Social Security.

The new rules permit a certain amount of disparity for defined contribution plans by requiring that the excess contribution percentage (the contribution percentage with respect to compensation above the integration level) may not exceed the base contribution percentage (the contribution percentage with respect to compensation below the integration level) by more than the lesser of:

a. The base contribution percentage or

b. The greater of

(1) 5.7% or

(2) The percentage equal to the §3111(a) tax rate attributable to old-age insurance.[16]

This is the third set of defined contribution integration rules for plan sponsors within the last six years. Further, the IRS issued Notice 89-70 which supplements the above rules by reducing the permitted disparity for certain plans where the integration level is less than the Social Security wage base.

Similarly, defined benefit plan integration rules require that, for non-offset plans, the excess benefit percentage (computed in the same manner as defined contribution plans except that it is for benefits attributable to employer contributions, not contributions) cannot exceed the base benefit percentage by more than the maximum excess allowance, benefits be based on average compensation, and any optional forms of benefit be provided with respect to compensation below the integration level. The maximum excess allowance is equal to 3/4% for benefits attributable to any year of service with the employer and, for total benefits, is equal to 3/4% times years of service up to thirty-five years.[17] The 3/4% is further reduced, pursuant to Notice 89-70, for certain plans where the integration level is less than covered compensation.

The recent regulations and the supplemental notice implementing the TRA 86 rules have been widely criticized as being very complicated.

<u>Proposal and Rationale</u>

The concept of permitted disparity should be either altogether eliminated or returned to its pre-TRA 86 status. A complete repeal of permitted disparity rules would reduce the

complexity of the qualified plan area and would generally provide greater benefits to employees in those plans currently using the permitted disparity rules. Repeal of the disparity rules could, however, lead to termination of existing plans. Therefore, if complete repeal is not desired, the pre-TRA 86 rules should be reinstated because of their relative simplicity.

Reduction of Complexity Achieved

This proposal would repeal §§401(l), 401(a)(5), and 401(a)(15).

Proposal: Simplify the combined plan limitations of §415(e) and repeal §4980A

Current Law

Where an employee of the same employer is covered by a defined benefit and a defined contribution plan, §415(e) imposes a limitation that prevents an employee from accruing the maximum benefits otherwise allowable under §415 under both the defined contribution and the defined benefit plan. Section 415(e) requires a calculation of a defined benefit fraction and a defined contribution fraction, the sum of which may not exceed 1. These fractions are based on the benefits provided under the plan versus the maximum benefits allowed by law. In some cases, these calculations require yearly monitoring. In other cases, the §415(e) result is not known until an employee terminates employment or retires.

Section 4980A, enacted by TRA 86, places a 15% excise tax on certain distributions that exceed $150,000 a year or lump-sum distributions that exceed $750,000 a year. These rules diminish the value of large accumulations within qualified plans even though the §415(e) limit may have been followed in the past.

Proposal and Rationale

Employees who are benefited by a defined benefit and defined contribution plan of the same employer should be subject to either §415(e) or §4980A but not both.

If §415(e) is to be retained, then §4980A should be repealed. If §415(e) is retained, it should be revised to be based on a plan design approach rather than on an actual accrued benefit approach. For example, if 100% of the defined benefit plan limit is being accrued for an individual, then only 25% of the maximum defined contribution limit would be provided for an individual under a defined contribution plan. (These percentages are used for illustrative purposes only.) This would eliminate the need for the annual cumulative calculation that is required under current law.

If, however, §4980A is maintained in the law, then §415(e) should be repealed and the maximum benefit should be allowed to accrue in both defined benefit and defined contribution plans.

Reduction of Complexity Achieved

The simplification achieved is the repeal of either §415(e) or §4980A.

Proposal: Simplify the coverage rules by repealing the second part of the average benefits test.

Current Law

Section 410(b) provides two ratio tests and an average benefits test; one of these three tests must be satisfied by a plan if it is to satisfy the coverage tests and qualify under §401(a). The average benefits test is a two part test: (1) a fair cross-section test comparable to pre-TRA 86 rules, and (2) the average benefit test which provides that the average benefit for nonhighly compensated employees must be at least 70% of the average benefit for highly compensated employees. A benefit percentage must be calculated for each employee and all benefit percentages within the two groups then averaged. The benefit percentage is the employer-provided benefit divided by compensation. Regulations explaining average benefits have not been issued. Temporary regulations have been issued that provide percentage safe harbors, based on coverage, for the fair-cross-section test part of this test.

Prior to TRA 86, there were two ratio tests and a fair-cross-section test, but the fair-cross-section test did not have an average benefits test. Guidance on the fair-cross-section test was found primarily in revenue rulings. The fair-cross-section was a subjective test with no safe harbors.

Proposal and Rationale

The average benefits test should be repealed. Section 410(b) is designed to test coverage and not benefit accrual. There are other sections of the Code that deal with nondiscrimination in benefit accrual, and that concept should not be tested with coverage. This approach adds complexity and substantially overlaps with other requirements of the law, such as §401(a)(4).

Reduction of Complexity Achieved

The simplification achieved is the repeal of the average benefits test found in §410(b)(2)(A)(ii).

Deduction Proposals

Proposal: Apply §404(a)(1) only to defined benefit plans.

Current Law

Section 404(a)(1) currently limits the amount deductible for contributions to pension plans. Pension plans include defined benefit plans and money purchase pension plans, a form of defined contribution plan.

Proposal and Rationale

Given the earlier proposal to classify all plans as either defined benefit or defined contribution plans, §404(a)(1) would only apply to defined benefit pension plans.

Reduction of Complexity Achieved

The reduction in complexity achieved would be the consistent treatment of money purchase pension plans throughout the Code.

Proposal: Apply §404(a)(3) to all defined contribution plans.

Current Law

Section 404(a)(3) limits the amount deductible for contributions to profit-sharing plans and stock bonus plans.

Proposal and Rationale

Section 404(a)(3) should limit the deduction for all types of defined contribution plans instead of for just profit-sharing and stock bonus plans. After this change, the deduction limit for money purchase plans would be found in §404(a)(3). A further simplification is the coordination between the 15% ductibility limit in §404(a)(3) and the 25% contribution limit in §415(c). The §415(c) and §404(a)(3) limits would be the same--for example, 25% of compensation.

Reduction of Complexity Achieved

Again, one set of terms would be used consistently throughout the Code. This proposal would also eliminate the necessity of maintaining two plans, a money purchase pension plan and a profit-sharing plan to achieve the maximum level of contribution allowable under law for defined contribution plans, while retaining maximum flexibility.

Distribution Proposals

Proposal: Repeal five-year averaging for distributions from qualified retirement plans.

Current Law

An individual can receive his or her entire balance from a qualified plan in one year and elect five-year averaging.[18] Five-year averaging in certain situations lowers the tax that would otherwise be paid if the entire distribution were to be included into income in one year.

Proposal and Rationale

The proposal is that five-year averaging be repealed. Lump-sum distributions would be included in income in the year received and taxed as ordinary income unless rolled over into an IRA.

Congress has become increasingly concerned that retirement plan balances are being used to fund expenditures unrelated to retirement, e.g., venture capital. Studies indicate that lump-sum distributions are often depleted by the time an employee reaches retirement age. Repeal of favorable tax treatment is intended to encourage using retirement funds to pay for living expenses upon retirement. This would also simplify decision making for plan participants at retirement by eliminating one of the current taxation alternatives. It is not recommended that lump-sum distributions from plans be prohibited because of the administrative convenience of paying an employee's balance, especially smaller sums, upon termination of employment. What would be eliminated would be preferential tax treatment if the distribution were not rolled over into another qualified plan or IRA.

Reduction of Complexity Achieved

Repeal of five-year averaging would eliminate the following Code sections: 402(e)(1),(2),(3), 402(e)(4)(B),(C),(D)(G), (H),(M), and (O).

Proposal: Allow the rollover of any distribution from a qualified plan, other than required minimum distributions.

Current Law

Section 402(a)(5)(D) allows for the rollover of partial distributions into IRAs. To qualify as a partial distribution, the distribution must be at least 50% of the account balance of the participant and must be payable because of death, separation from service, or disability. This provision was enacted as part of the Deficit Reduction Act of 1984 (DEFRA). Prior to DEFRA, only total distributions could be rolled over. Congress enacted this provision so that rollovers could still be allowed even though a participant inadvertently received less than the total plan balance.[19] It is not clear why a 50% threshold was chosen, particularly since current law allows any portion of an otherwise qualifying distribution to be rolled over even if it is less than 50% of the distribution.

Proposal and Rationale

Any distribution from a qualified plan should be eligible to be rolled over into an IRA except for distributions pursuant to §401(a)(9). This would simplify distribution planning and encourage retention of funds originally contributed to retirement plans for retirement. It would also eliminate the disparity between the amount required to be distributed to be eligible for a rollover and, at the option of the recipient, the lesser amount that is permitted to be rolled over.

Reduction of Complexity Achieved

Section 402(a)(5)(D) would be repealed and the definition of a qualified total distribution would no longer be necessary.

Proposal: Simplify the minimum distribution rules of §401(a)(9).

Current Law

Section 401(a)(9) provides for the systematic distribution of qualified plan and IRA benefits over an individual's and beneficiary's life expectancy beginning at age seventy-and-one-half.

Proposal and Rationale

The minimum distribution rules are aimed at preventing plan participants from using qualified retirement plans as estate planning devices. With the repeal of the estate tax exclusion in DEFRA for qualified plan interests, a strong argument can be for the repeal of §401(a)(9). However, even after DEFRA, participants could still receive a significant tax advantage by deferring the receipt of their benefits to a date in the distant future. Two changes can be made to simplify §401(a)(9) without compromising the purpose of the provision. First, at death, distributions could be required to be paid over the life expectancy of the beneficiary beginning at the decedent's death. There would be no distinction between situations where an individual dies before or after his required beginning date. There would also be no distinction between types of beneficiaries as there is under current law. Second, the calculation of life expectancy should not be recalculated. The only method of determining life expectancy would be reducing the initial calculated life expectancy by one each year. Both of these suggestions are intended to streamline §401(a)(9) without altering the underlying concept. Finally, consideration should be given to reducing the number of participants to whom this rule applies by limiting its application to participants with accrued benefits in excess of a certain level.

Reduction of Complexity Achieved

Section 401(a)(9)(B) would be condensed from four rules for distributions upon death to one rule. The regulations would be simplified concerning the calculation of life expectancy.

Proposal: Eliminate hardship withdrawals from 401(k) plans.

Current Law

Under current law, hardship withdrawals based on need can be made from cash or deferred arrangements under §401(k). However, such distributions are subject to a 10% additional income tax under §72(t) if the distribution is made prior to age 59-1/2, with some exceptions.

Proposal and Rationale

The ability to receive a hardship withdrawal from a §401(k) should he eliminated. An underlying premise of this paper is that qualified retirement plans should provide replacement wages at retirement. Hardship withdrawals tend to undercut this purpose.

From a reduction-of-complexity point of view, the existing regulations can require a significant amount of paperwork. Hardship withdrawals have been voluntarily eliminated from many 401(k) plans since 1986 for two reasons: (1) enactment of the §72(t) excise tax as part of TEA 86, and (2) the amount of paperwork required of an employer under the regulations. Eliminating hardship withdrawals would simplify the law and would also help to ensure that benefits are available for retirement purposes.[20]

One objection to the elimination of hardship withdrawals is that the elimination would discourage participation among the rank and file. An alternative to elimination is simplification of the regulations. For example, hardship distributions could be allowed for a home purchase, education, or medical expenses. No other showing would be necessary.

Reduction of Complexity Achieved

The complicated plan amendments required as a result of the proposed and final regulations on hardship withdrawals in 401(k) plans which were issued on August 8, 1988, would no longer be needed, and the role of plan administrators in administering affected 401(k) plans both now and in future years would be simplified.

Controlled Group Proposals

Proposal: Better define the terminology used in §§414(m) and 414(n) and repeal §414(o).

Current Law

Section 414(m) provides rules which treat all employees of members of affiliated service groups as employed by a single employer for certain qualified retirement plan purposes. In general, there are two sets of rules in §414(m): affiliated service group rules and management group rules. Section 414(n) provides similar rules concerning certain leased employee arrangements. Section 414(o) provides a broad grant of regulatory

authority for the IRS to deal with business arrangements which would allow for circumvention of the qualified plan requirements.

Proposal and Rationale

The §414(m)-affiliated service group definitions under the Code and the regulations are extremely complex. If Congress wishes to prevent the perceived abuse at which §414(m)(2) was aimed, it appears that much of the complexity would have to remain. However, it would be helpful if some of the terms used in the Code were more clearly defined. The use of too many qualitative terms causes plan sponsors and their advisors to spend extra time and effort in attempting to interpret them.

First, the definition under §414(m)(2)(A)(ii) could he changed to state that "if more than 25% of the services performed by the A organization are for the first service organization" instead of using the amorphous term of "regularly performed." Also, de minimis ownership should be ignored under §414(m)(2)(A)(i), e.g., ownership of less than 1%. Under the B organization definition, the phrase "significant portion" should be defined as 25% or more.

With respect to §414(m)(5), the "principal business" should be defined in the Code as the business constituting 50% of gross revenues. In addition, firm management functions should be defined as executive-type functions rather than permitting the regulations to expand that definition to include professional services. Simply rendering professional services for another organization should not cause the individual providing the service to be aggregated with the recipient organization on that basis alone.

Section 414(n) is a fairly straightforward Code provision aimed at abusive situations where employers do not employ their own employees, but rather lease employees from a third organization. This provision should be clarified so that it does not cover independent contractors where there is no third-party leasing organization involved. Also, it would be helpful if the reference to §144(a)(3) under §414(n)(6) were eliminated, as it makes analysis under this Code provision extremely difficult. Finally, §414(o) should be eliminated entirely, as it has made it virtually impossible for a sole proprietor and other small businesses to determine eligibility for pension plan contributions when it is involved in any way with any other entity. For example, an employee who is a 5% owner of a company and who also works for another company must determine whether the two companies are recipients under §1.414(n)-1(b)(2) and (b)(6), which in turn, requires an analysis under §§414(b), (c), (m), and (o) and also under §144(a)(3), and with respect to any organization under §§414(b), (m), and (o) and §144(a)(3) requires an analysis of whether there is aggregation under §§267, 707(b) or members of controlled groups as defined in §1563, substituting 50% for 80%. This analysis is beyond the ability of most sole proprietors (and many practitioners), and would probably cost more in advisor's fees than what many sole proprietors would gain by taking the pension plan deduction.

Reduction of Complexity Achieved

Making the statute more specific will assist plan sponsors and their advisors in interpreting and applying these provisions.

EMPLOYEE BENEFITS OTHER THAN QUALIFIED PLANS

Benefit Proposals

Proposal: Repeal the death benefit exclusion of § 101.

Current Law

The maximum amount that may be excluded from gross income with respect to the death of any employee may not exceed $5,000. An allocation of the exclusion is required if multiple beneficiaries receive, in total, greater than $5,000.

Proposal and Rationale

The exclusion of death benefits from gross income in an amount of $5,000 should be repealed. The utility of this provision is very limited, and it is recommended that it be eliminated in the interest of reducing complexity. Employers could still make payments of this nature upon death but they would not be excluded from income taxation.

Reduction of Complexity Achieved

This would result in the repeal of § 101(b).

Proposal: Repeal the tax-favored status of group legal services plans.

Current Law

Group legal services plans permit an exclusion with respect to an individual on an annual basis of no more than $70.

Proposal and Rationale

The exclusion currently contained in 120 should be repealed. The growth of these plans has not been widespread, and the current $70 limit is so small that the reduction of complexity would seem to dictate repeal of this provision.

Reduction of Complexity Achieved

Section 120 would be repealed.

Proposal: Provide the educational assistance exclusion on a permanent basis

Current Law

An employee can receive an exclusion from income for the first $5,250 of educational assistance received pursuant to a qualifying educational assistance program under § 127. In order to qualify, the plan had to meet certain nondiscrimination requirements.

Without § § 127, certain employer-provided educational expenses would be excludable under § 1.162-5 of the regulations. To qualify under the regulations, an employee's expenses must be job-related, which means that the expenses must either:

a. Meet the express requirements of the individual's employer or the requirements of applicable law or regulations; or

b. Maintain or improve the skills required by the individual's employment or other trade or business.

Proposal and Rationale

The rules contained in § 127 are easier to understand and administer (for both employers and the government) than the rules contained in the regulations. Although the regulations limit qualifying expenses to employment-related expenses and are more targeted than those of § 127, they have spawned much confusion and substantial litigation. In the interest of simplicity, the rules of § 127 should be implemented on a permanent basis.

Reduction of Complexity Achieved

Permanent enactment of § 127 would eliminate uncertainty among employers as to tax-reporting rules regarding this area in the future. It would also simplify the substantive rules in the area and eliminate a source of controversy between taxpayers and the IRS.

Proposal: Raise the § 79 group-term life insurance exclusion or eliminate the exclusion entirely.

Current Law

Section 79 excludes from gross income the cost of the first $50,000 of group-term life insurance with certain exceptions. The exclusion is not available to sell-employed individuals.

Proposal and Rationale

There appears to be no valid reason why group-term life insurance should be subject to tax for employees above a certain level while group medical, dental, vision, accidental death and dismemberment, and similar coverages are not taxed. The current low level of exclusion requires employers frequently to impute income to employees for group-term life

insurance. In view of these two considerations, the current exclusion level should be increased or the exclusion should be repealed. An overall higher cap could be added such as $200,000, which would be indexed, or the cap could be tied to a multiple of compensation.

Reduction of Complexity Achieved

Increasing the $50,000 threshold would reduce the complexity implicit in this section of the Code. Since close to half of all families receive some employer-provided group-term life insurance, and given the lower rates generally available through group-term insurance, the better approach may be to increase the $50,000 threshold.

Nondiscrimination Proposals

Proposal: Establish a uniform set of design-based standards for nondiscrimination under employer-provided health, welfare, and fringe benefit plans.

Current Law

The Code currently contains a confusing pattern of rules for nondiscrimination testing in the fringe benefit area. With the repeal of §89, the rules now in effect reflect a patchwork of varying nondiscrimination tests enacted over the years. Examples of these tests can be found in §§79, 105(h), 120, 125, 127 and 129.

Proposal and Rationale

All the varying discrimination tests should be eliminated and a uniform three-pronged test be instituted for each benefit. This test should be a design-based test as opposed to a usage test. This would mean that the following three tests would be used for all health and welfare plans:

a. Eligibility Test

A plan must contain no discriminatory provision as to eligibility to participate in the plan.

b. Affordability

A plan would have to be affordable. In order to be considered affordable, the cost to employees could not exceed 50% of the total cost of the plan.

c. Benefits Test

The maximum tax-favored benefit that a highly compensated employee could receive could be no more than 150% of the employer-provided benefit for the nonhighly compensated.

The following changes would also be made in adopting these rules:

(1) Part-time employees should be defined to mean those with less than 1,000 hours of service per year.

(2) Independent contractors should be completely excluded from consideration under these tests unless more than 1,000 hours were worked for an employer in the preceding year.

Reduction of Complexity Achieved

This would help to eliminate confusion and uncertainty in this area in the future. By making the test design-based instead of usage-based, employers can be assured that their plan qualifies for preferential tax treatment without the complexity extensive usage testing involves.

Proposal: Establish a uniform definition of the prohibited group for purposes of the health- and welfare-plan nondiscrimination rules.

Current Law

At least three different definitions of the prohibited group are used in the fringe benefit area: key employees, highly compensated employees, and shareholders or owners, each of whom owns more than 5% of the stock or of the capital or profit interest in the employer.

Proposal and Rationale

The uniform definition of highly compensated employees as set forth in §414(q) should be used for this purpose. This would allow the same definition to be used for virtually all employee benefits purposes in the Code, greatly reducing the complexity in this area of the law.

Reduction of Complexity Achieved

The repeal of §§125(b)(2), 127(b)(3), 129(d)(4), 129(d)(7), and 79(d)(3) would be a direct result. Reducing the complexity of the testing rules would eliminate much of the confusion surrounding this area of the law.

Administration

Proposal: Change the COBRA list of qualifying events to apply the thirty-six month period to terminations and reduced hour.

Current Law

Currently, the §4980B(b) penalties are levied upon the employer if the proper notices and opportunity to elect, regarding health care continuation coverage, are not given to employees who terminate service or work reduced hours (for any reason other than gross misconduct). Two qualifying events cannot result in greater than thirty-six consecutive months of required continuation coverage.

Proposal and Rationale

Section 4980B(f)(2)(B)(i)(I) should be amended to include employment termination for any reason except gross misconduct within the thirty-six month category. The effort here is to add a uniform three-year standard for all significant employee life events except gross misconduct.

There appears to be little justification for the extended period to be denied to terminating employees and their families, who may need the coverage just as much as individuals in any of the other qualifying event categories.

Reduction of Complexity Achieved

Repeal of the general rule for terminations and reduced hours under 4980B(f)(2)(B)(i)(I) and the special rule for multiple qualifying events under §4980B(f)(2)(B)(i)(II).

SUMMARY

It is possible to substantially reduce the complexity in the rules governing the taxation of employee benefits while still achieving virtually all of the policy objectives of current law. The process of reducing complexity in the employee benefits area involves two steps. First, the existing rules must be restructured into a comprehensive statute. This requires clarity of purpose and entails the elimination of a number of provisions which are largely or partially duplicative. Second, both the statutory and regulatory rules need to be amended to focus on the general rules instead of the exceptions. In an effort to prevent the contravention of legislative intent, the Congress, the Treasury Department, and the Internal Revenue Service have crafted rules so complex that not even the most skillful practitioner, Internal Revenue agent, or employee plans specialist can comprehend the full import of the rules. Taking this second step means modifying or eliminating those rules whose incremental contribution to equity is outweighed by their incremental contribution to complexity. Even at a time of significant budget deficits, implementing these two steps does not have to be difficult, since some changes will raise revenue while some will reduce revenue. Unless the complexity of the employee benefit rules is reduced, the trend is likely to be increasing noncompliance--not intentional but unintentional, brought about by taxpayers' inability to understand what is expected of them under the law--and a weakened private pension system.

ENDNOTES

[1] I.R.C. §401(a)(27).

[2] I.R.C. §401(a)(23).

[3] I.R.C. §§4975(d) and 401(a)(13).

[4] I.R.C. §414(q).

[5] Gridlock, "Pension Law in Crisis and The Road to Simplification," *APPWP*, (September, 1989), 19 [hereinafter Gridlock].

[6] Staff of the Joint Committee on Taxation, 97th Cong., 2d Sess., General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982 at 309 (Comm. Print 1982).

[7] I.R.C. §§401(a)(17) and 411(a).

[8] I.R.C. §416(c)(1).

[9] I.R.C. §416(c)(2).

[10] I.R.C. §416(e)

[11] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 at 683 (Comm. Print 1987).

[12] Id.

[13] Treas. Reg. §1.401-14(c)(1).

[14] Gridlock, supra note 5 at page 20.

[15] F or a similar proposal, see Id. at page 23.

[16] I.R.C. §401(1).

[17] I.R.C. §401(1)(4).

[18] I.R.C. §401(e).

[19] Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 809 (Comm. Print 1984).

[20] Gridlock, supra note 5 at page 36.

COMMENT ON "EMPLOYEE BENEFITS: STATUTORY SIMPLIFICATION"

HARRY J. CONAWAY*

My intent this morning is really not to debate Dave Kautter about the points that he has raised. I want to focus instead on some thoughts that I had about simplification in the employee benefits area and then some thoughts I had about some specific proposals, some of which Dave mentioned and some of which he didn't. I'm sure some of these points have been made in other parts of the conference, but I thought that they would be useful to go through quickly here just for a few minutes.

It first struck me that one thing in the simplification debate that is rarely done is to identify the level that we're talking about, the level at which we desire simplification. Is it the written law we're talking about? Is it the regulations or implementation of the regulations? Is it the practical effect on plan sponsors or the practical effect on individual taxpayers? Is it plan design that we're talking about, or is it plan administration that we're talking about?

We can all conjure up examples where a simple written law, such as taxing all real economic income, may be overly difficult and complex in practice to apply. Obviously, a complex law in terms of the words in the statute, the pages in the statute, may be relatively simple in practice to apply and to design around. So I think one thing we need to do in this debate is identify the level that we're talking about, the level of simplification we're talking about.

A second point is to recognize, as I'm sure most of you do, that in many cases simplification and fairness or flexibility are enemies. In the legislative process, arguments are often made successfully for special rules, grandfathers, and other transition rules which

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Mr. Conaway is a graduate of Trinity College of Connecticut (B.A.), holds an M.A. from the University of Pennsylvania, and a J.D. from the George Washington University in Washington, D.C. He is a member of the Employee Benefits Committee of the Tax Section of the American Bar Association and of several other professional and employee benefit associations. Mr. Conaway is a frequent speaker, panelist, and author on employee benefits.

have significant fairness arguments in their favor. But there's no doubt they complicate the written law and, in many cases, make practice more difficult for plan sponsors and for individual taxpayers.

Another area is that simple rules, across-the-board rules, may be arbitrary vis-a-vis plan sponsors' practices. More complex rules may fit more reasonably with sponsors' existing practices and, therefore, may be less disruptive. Life is complex as we know it, and much of the complexity that we're talking about is the tension, the rubbing that occurs between these laws and what employers are doing in practice. It takes complex rules to properly fit complex designs and practices.

Another issue under this category, the fairness/flexibility category, is the horizontal- and vertical-equity goals that are so often talked about in the tax policy arena. Simple rules in many cases may fail to achieve these justifiable policy goals.

Also, it seems to me, it's important to separate the simplification issue from the issue of whether the rule should be tougher or looser. Many, both on the plan sponsor/taxpayer side and on the Government side of an issue, often use simplification as a front for their substantive law, policy preference. Simplification seems to be the second and the third priority or argument on nearly everybody's list, depending upon whether they favor or oppose the rule at issue.

Another thing I think people should keep in mind is the importance of distinguishing complexity at the margins in an area from mainstream complexity. We're all aware of plan sponsors who attempt to run at the edge of permissible practices, and the rules at the edge tend, in many areas, to be more complex. In many areas, sponsors could decide to run their plans less at the edge of the permissible law and more in the mainstream and essentially elect out of much of the complexity that the laws would otherwise impose. So I think you need to distinguish, when you talk about a rule, between complexity at the margin and complexity in the mainstream.

We've all worked on plans--I was thinking, coming over here, of some of the plans that I've worked on in private practice--where the first half of the plan is the current part of the benefit formula, the eligibility rules, and the last half is the grandfather rules and other special rules given the different categories of employees, perhaps justifiably, given the plan sponsor's employee benefit objectives. But, nonetheless, this increases complexity significantly.

In the benefits area in particular, in assessing the complexity issue, as with any issue, it's important to step back and identify basic principles. In the benefits area, using the debatable tax expenditure point, the estimated tax expenditure in the pension area is about $50 billion a year; in the health area, it's about $30 billion a year. And assuming continuation of favorable tax treatment for employer-provided pensions and health benefits, particularly in an era of budget deficits and where there seems to be a consensus about trying to reduce the deficit, I think it's reasonable to expect that Congress, any Congress and any administration, would want to regulate the availability of the favorable tax treatment. Congress and an administration would care about targeting the tax expenditures

at the intended beneficiaries. This would be for revenue reasons, equity reasons, and a whole variety of reasons I've already mentioned.

The multiple and not entirely consistent set of objectives in the employee benefits area--that is, there are a set of labor objectives, there are a set of health objectives often, a set of pension policy objectives, and a set of tax objectives--further contribute to the complexity in the area. The attempt to balance these different policy objectives, I think, results in necessarily, in many cases, but unfortunately complex rules, limiting the availability of the favorable tax treatment.

I think, in addition, the legislative and the regulatory process significantly increase the burden and complexity on plan sponsors. Many times there are short compliance deadlines, not only for plan sponsors but also for the IRS in terms of giving guidance. This only furthers the uncertainty and at least the feeling of complexity and burden on the private-sector side.

I want to take, now, a couple of basic areas, some of which Dave mentioned, and discuss them. The main one, it seems to me, has to do with the nondiscrimination rules. Generally, it's thought that there are two basic approaches to achieving nondiscrimination policy objectives in the benefits area. One is what Dave ended up on, more of a design-based approach laying out the standards that a plan design must conform to, and if it does, then it's deemed to be nondiscriminatory, versus a more flexible approach, an approach that says the employer doesn't have to design its plan to satisfy the X, Y, and Z standards, but what we'll do is look at what is actually occurring under the employer's plan and then we'll determine whether those results are themselves discriminatory or not discriminatory--really a design-based approach versus an annual testing approach.

In the top-heavy area, in section 416, and in the minimum participation area, section 401(a)(26), Dave proposed the repeal of section 416 and the reconsideration, at least, of 401(a)(26). I think these are good examples of design-based approaches to nondiscrimination. There's no annual testing and retesting. It's in most cases a matter of the employer's designing its plan to meet certain characteristics, and the likelihood--the probability--of discrimination is reduced thereby. If the rules were more fully applied, it's very possible that other, more difficult nondiscrimination rules could be totally eliminated.

The 401(a)(4) approach, what is called the general nondiscrimination approach, really is more of an annual testing approach. That's looking at what benefits are actually provided under the plans, what contributions are actually provided under the plans. And this is the approach that really requires an actuary to get in and make actuarial comparability determinations, to try to project salaries and other factors, both current factors and possible future factors, and determine benefit rates so that a determination can be made about whether the plans are actually providing discriminatory or nondiscriminatory benefits. So these are the two basic approaches. Dave proposed the repeal of the design-based approaches here.

Then we turn to 401(k) and the 70-percent-average benefit test enacted in the '86 act under section 410(b), the minimum-coverage rules. These are both examples of the

latter type of approach, the annual testing, the actuarial comparability type of approach to nondiscrimination. Dave, here, proposed to repeal both of these as well. So at least in Dave's proposal, we don't have design-based tests, and we don't have annual testing.

The point that I want to make here is that in considering the nondiscrimination objective, assuming that there are to be nondiscrimination rules, and without getting into how tough or easy they should be, there needs to be a consensus. First there should be an explicit recognition of the nature of the different type of approaches, and then a discussion, a debate, and hopefully an agreement about the type of approach that will achieve the nondiscrimination and other objectives while minimizing the burden on plan sponsors, on plan administrators, and assuring compliance with the standards.

Another proposal raised in Dave's piece is to repeal the 415(e) combined plan limit and to reconsider or repeal the 4980A excise tax on excess distributions. The 4980A excise tax was originally a Treasury proposal, and certainly it's my personal view that the tradeoff of retaining 4980A and repealing 415(e) would be a sensible tradeoff. The excise tax on the individual recipient is a fairer, more effective way to limit the availability--or the receipt--of the tax preference.

However, from a simplification point of view, I think it's important to note that even though 415(e) requires the sponsors to undertake a very complex calculation, it's a burden that falls on plan sponsors. It's not a burden that falls on individual taxpayers. 4980A is a tax on individuals, and what that does, while achieving the same general policy purpose, is put the burden clearly on the individual taxpayer. I think in assessing simplification, again, identifying what we're talking about and who we want to simplify for, you need to factor in the question of whether burdens, to the extent that they're necessary to assure compliance with policy objectives, should be placed on plan sponsors or on individual taxpayers.

On the section 402 distribution rules, there's no doubt that the detail--the complexity--there is really an embarrassment. There have been many proposals floated that would neither pick up nor lose revenue that could drastically simplify this area. I know the Employee Benefits Committee, the Tax Section of the ABA, was considering such a proposal a couple of years ago. I think there are a lot of things that can be done in that area.

I think it's important to review the balance between the labor and the tax rules. Many labor-type rules are in the Tax Code and, thus, are associated with a tax-disqualification sanction where those rules might be more appropriately enforced solely by a labor-law-type sanction, employee lawsuits, and the like. It could well be that this sort of assessment and reallocation of rules between the labor and the tax side would further simplification.

Finally, I want to close with a proposal, and this is something that, when I was at the Treasury Department, we discussed sort of walking down the halls and at the end of meetings, after pulling our hair out trying to think through some of the rules and what regulations would be required. The proposal that we discussed is essentially as follows:

Congress, Treasury, the Labor Department, and the private sector would join together to design ten basic qualified plans, five maybe, fifteen maybe, any of which employers could adopt, perhaps with some variations. And that would be it for qualified plans--the flexibility, the ability to individually design programs for a variety of albeit justifiable reasons, would be eliminated. The idea was that if the tax preference for retirement savings is to be continued, and the qualification system simplified, one way to do it is essentially to expand the IRS's existing master- and prototype-type program--although this would permit slightly more flexibility than the proposal I just discussed--and extend the master- or prototype-plan approach to the entire private sector retirement system. I present these approaches for discussion purposes.

COMMENT ON "EMPLOYEE BENEFITS: STATUTORY SIMPLIFICATION"

SUSAN P. SEROTA*

Good morning. I think at the outset that we should recognize that the uniqueness of the employee benefits area is not due solely to the Internal Revenue Code. After all, the employee benefits plans, pension plans, profit-sharing plans, and other types of plans are really governed by numerous laws, all of which plan sponsors have to basically comply with. Indeed, we have a number of different agencies that we have to deal with and meet their types of regulations. The laws, of course, are ERISA, the Code, labor laws, ADEA, and securities laws. There may be others out there that I have not mentioned.

The second factor that we should take into account, I think, from the outset is the fact that there are more than $2 trillion in plan assets, which is awfully difficult to ignore as a source of potential revenue.

Thirdly, I think we should recognize that there are really two competing forces in Congress and among the different agencies: the force of a national retirement policy versus the amount and type of revenue subsidy that should be given to qualified plans. These forces result in a constant tension up on the Hill, in the agencies, and in private practice as we try to deal with these issues.

My employee benefits practice has developed tremendously over the years that I've been in it. I started in what I called pension law--I called myself a tax lawyer then. I no longer call myself a tax lawyer; now I call myself an employee benefits lawyer because I don't just deal with the Internal Revenue Code.

When I lecture to the summer associates who come to my law firm, or sometimes even to the partners and other associates who come to listen to me because employee benefits has proliferated through other areas of law, they want to know what issues they

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Ms. Serota received a B.A. from the University of Michigan (1967) and a J.D. from New York University School of Law (1971), where she was the Editor of the Second-Year Writing Program Subsection on Tax. She has served as the Chair for the American Bar Association Joint Committee on Employee Benefits, as the vice-chair of the ABA Section of Taxation Committee on Employee Benefits, as a member of the Executive Committee of the New York State Bar Association Tax Section, and as a member of the District of Columbia Bar Association.

have to be aware of. I tell them the story of the development of my practice. When I started out, I had an office at the end of the hallway, and nobody came to talk to me because nobody really cared. I mean, I was a specialist in tax law and pensions, I knew what the qualification rules were, and I dealt with them, and everybody said, "Fine, Susan will take care of it."

Then ERISA was passed, and all of a sudden there were specific liabilities that could be imposed on corporations' assets due to the funding of pension plans and the termination of pension plans. And who were the first lawyers to find me? They were the creditors'-rights lawyers in the firm. They suddenly started walking down to my office and saying, "We have this loan agreement, and we want to make sure that our client, the lender, is protected against this potential PBGC lien." And I told them, "Well, this is what you have to do and this is what you have to worry about," and they'd go on their merry little way. They'd say, "Okay, Susan took care of it."

Well, as time went on and as the economy developed and the acquisition and merger area emerged, they said, "You know, pension plans not only are a liability, they're also an asset. And shouldn't we really be either buying or selling this asset? And how do we deal with all the issues that are involved with pension plans?" And so they'd come down to my office, and we'd talk and we'd sit down and develop certain representations and warranties, and then went on to talk about what you do with these plans once you've acquired them, or what you are going to do with the plan once we've sold off the division or the subsidiary that participated in this plan.

And they'd say, "Okay, Susan, and now her associates are taking care of all of this for us, and everything's just fine." Then all of a sudden ESOPs came into the forefront in the area of acquisitions, mergers and lending and financing, and they said, "Oh, my God, we don't even know how to structure the deal. We'd better go down to Susan's office and talk to her before we can even start the deal." All of a sudden I realized that employee benefits had made the day.

Seriously, this area has become so complex that I am now in the position of not only saying that I don't know the answer, I'm in the position of saying I don't know when I'm going to know the answer. It's very difficult to practice in an area that is constantly changing. It's an area in which, as we mentioned earlier, there have been fourteen different laws since 1974, numerous regulations both in proposed and final form that have been issued. For example, the area of 401(a)(9), I think, has been revised and amended four times in the last eight years.

This has been an area of constant change and constant complexity. It's one that we really have to turn to and deal with in some sort of systematic manner. It also seems to me that simplification is a concept that is misconstrued, both by the congressional staff who often thinks that simplification means giving employers too much discretion, and by the private bar, who believe that simplification may often mean a loss of flexibility.

When we talk about complexity in the Internal Revenue Code, we are really talking about an unacceptable degree of specificity and detail that comes from three sources, not

perhaps two, as David mentioned. David mentioned, obviously, the sort of incremental overload, the layering of tax laws and regulations one on top of the other, some of which are left to atrophy throughout the Code and clutter it up. The other one, of course, is this obsession, that he so termed, of chasing tax abuse and making sure that this is a perfect system of providing pension equity. The result has been an explosion in the number of rules and regulations that any particular plan needs to comply with.

But a third source of complexity in the Code is one that we practitioners are really responsible for, and we have to take the credit for. That is that we want to permit plan variability. We do not want standard plans, or at least our clients don't want standard plans. We don't want the four or fourteen different variations that Harry and I and someone else may possibly dream up, thinking that these are the perfect type of plans that would solve all our problems. The problem is that most plan sponsors of substantial plans really want to keep the type of arrangements they've had that they feel are providing good retirement benefits for their employees.

The first source of complexity that David talked about is this layering effect. I think David has presented, overall, ten good proposals to eliminate redundancy and improve the organization and neatness of the Code, and without substantially changing any policy. I may agree with some of his suggestions or disagree just in the level of where he's going, but I think, overall, he has made some good suggestions that we should all think about.

The second and third sources of complexity create somewhat of a dilemma for the government and the private sector. On the one hand, the government needs to recognize that much of the Tax Code's complexity comes from efforts to force plans designed and adopted to meet corporate needs to meet national social policy goals as well. Top-heavy rules, the 401(k) and (m) tests, 401(a)(26), all are complex provisions intended to provide higher benefits to lower compensated workers and prevent the highly compensated from receiving too much. Eliminating or greatly simplifying these rules would do much to simplify the Code but at the cost of pension equity.

This is the dilemma for the government. They have chosen to meet their own goals by harnessing private plans and redirecting them from fully meeting the employer's goals. Employers have an interest in rewarding their most productive and longest-service employees, while government has an interest in assuring that everyone receives equal retirement benefits. This creates unnecessary tension between the government and employers, resulting in inefficiency in meeting either goal. The government cannot fully meet its own goals, or employer interests will be sacrificed and plans will be terminated. We have seen this as legislation is enacted that requires more and more administration in order to keep plans in compliance, and more and more small employers continue to terminate plans.

The government must be willing to live with some degree of discrimination and inequity in the distribution of tax benefits. If tax equity or if pension equity is too important a goal to sacrifice, then the government has to provide the benefits itself or use, perhaps, Harry's suggestion of five, ten, or maybe fifteen different varieties, but those are the only ones that you can have.

The top-heavy rules are a perfect case in point. Most of the vesting and benefit accrual requirements of the top-heavy rules applied to small plans in 1982 were later largely duplicated by new vesting, and the permitted disparity rules applying to all plans after the 1986 Tax Reform Act. In fact, the top-heavy rules, even when they were first initiated in 1982, really applied to a very small fraction of plans, at least in my practice. I can't say about very many other practices. But I know that the only top-heavy plan I ever had to work with was the one for my own law firm. The only reason I had to learn about top-heavy rules was to be assured that for this one plan we didn't fall out of compliance.

On the other hand, every single plan that we were responsible for had to contain all of the 416 rules, and they never once went into effect. The only amendments that we were required to make half the times were little amendments to meet 416 requirements by the Internal Revenue Service in the determination letter process. This is just not an efficient way of administrating a law.

The top-heavy rules should be repealed because they are largely duplicative. And, in fact, the American Bar Association, at their annual meeting last August, resolved that these rules should be repealed. And this is true even though the top-heavy rules would eliminate a small minimum benefit that is required only for these type of plans. But the amount of complexity required to differentiate and regulate top-heavy plans is hardly worth the small increment of minimum benefit it yields for the relatively few workers it affects. If Congress is that committed to minimum pension benefits, it can meet this objective more efficiently by mandating a minimum pension accrual or simply raising taxes and increasing Social Security benefits.

Another example is the minimum participation rules which were mentioned earlier today, 401(a)(26), which generally require a plan to cover at least fifty participants or 40 percent of the work force. The original purpose of Section 401(a)(26) was to stop the proliferation and continued existence of individual defined benefit plans, which we might say were mostly being utilized by partners in law firms, accounting firms, and investment-banking houses. As David has stated, this is a statute that has run amok. It is posing large employer plans as much problem as the permitted disparity provisions of 401(l). It should be amended or repealed.

Let me give you two examples. We talked about the airline pilots earlier today. Well, that happens to be one of the problems with one of my very large clients, who has over 40,000 employees with respect to their retirement plan. They have only one retirement income plan. It covers all of their employees. They don't have one for hourly employees and one for salaried employees and the concern worrying about which plan is which. They have their one basic plan.

On the other hand, they have a lot of different benefits in that one basic plan. But as you talk about the airline pilots, they for many years have believed that most airline pilots--not in the commercial field but rather in the private area--have to or perhaps should be retired at age sixty. They basically have applied the rule that applied to commercial pilots to the private pilots.

I asked them, well, how many pilots do you have? And they said they have twenty-six pilots. I said, well, that's nice, but you don't have fifty. What is the problem? The problem is in the plane that they have a normal retirement age, not a mandatory retirement age, of age sixty in order to give them the full benefit at age sixty when they would otherwise potentially retire.

Well, this isn't going to meet the requirements of 401(a)(26). The problem is, of course, that pilots earn a lot of money, even in private industry. Actually, their average income in this case is probably just right below the level for being highly compensated in this company. But if that's the average, one of the special rules that was put into the 401(a)(26) rules just can't apply because there won't be enough pilots below that level to make it work. So I don't know what we're going to do about our pilots. We have to be concerned. Maybe we can fit into one of the regulatory exemptions. But we certainly can't fit into the one that's currently there.

The other one is one that, I think, is more broadly a problem for large employers. For example, this is a company that goes out and buys a number of companies. Typically when it goes out and buys another company, it gives past service credit for vesting and sometimes for benefit accrual, depending on what the former employer had provided.

Now, it turns out under the 401(a)(26) rules, each one of those different acquisition groups is going to be considered to be a separate benefit structure, and each one of them will have to be tested separately. This was not the intent of 401(a)(26). These are good benefits that are being provided, and the decisions being made are to bring these people up to the level of the benefits being provided for the employees of the overall corporation.

But it's not only, as I said initially, the government, the Service, or the Congress who is posing all of the problems. The private sector itself has to take some of this responsibility. A good deal of the complexity in the system comes from efforts to accommodate variability in the way plans are now designed. If the private sector wants simple rules and plans, the easiest way to do this is to have a federal prototype plan, such as Harry mentioned, that everyone has to adopt. If employers want to continue to maintain some flexibility in the design of their own plan, then they should be prepared to accept the complexity in the Tax Code needed to make this degree of flexibility.

Another example, of course, we could go into--and I won't because of the intricacy and the discussion already this morning--is pension integration. But, indeed, that's one area which has become so complex that plans that have been providing good benefits are having difficulty meeting the new rules that most employers now are doing nothing. We are now in the position of awaiting regulations that have yet to be issued to see whether or not, under the section 401(a)(4) nondiscrimination rules, these plans can continue as they always existed, or whether they have to change because they cannot meet the current permitted disparity rules.

It is relatively simple to eliminate some of the clutter in the Tax Code, but this would not have much effect on its complexity. The real complexity comes from a desire

to do too much. Real simplification requires employers and the government to be willing to live with less--less flexibility in plan design and less equity in benefit delivery.

In this context, I would set a priority on several proposals in David's draft. First, Congress should relax its efforts to require complete equity in pensions by repealing the top-heavy rules; repealing either the combined 415(e) limits or the section 4980 excise tax on excess distributions; repealing the 70-percent-average benefits test in 410(b); in addition, the Service should revise the regulations for section 401(a)(26), or, if necessary, Congress should amend the statute to greatly limit the application of the minimum participation rules to separate benefit structures. In each of these cases, the increment in potential for abuse or loss of benefits that would result in a change is small in comparison to the potential for greatly reduced complexity in the Code.

Secondly, employers should accept, in the name of simplification, some constraints on their freedom to design plans. The most important of these would be to permit integration in a more simplified but restricted basis. Simplicity in employee benefits comes at a tremendous price, and we should recognize that we may not want simplicity as a goal in and of itself. As long as we prefer a system that uses private plans to achieve public purposes, the tension between the conflicting aims of each always will result in statutory and regulatory complexity.

In conclusion: The world might be better served if Congress and employers could agree to sacrifice some of their objectives in the interest of a less complicated pension and employee benefit system. Thank you.

INCOME TAX COMPLEXITY: CAPITAL GAIN AND LOSS ISSUES

MARTIN D. GINSBURG*

This is a paper of narrow compass. Here you encounter little, if anything, of economic efficiency, stimulus to savings, fairness, equity horizontal or vertical, or much about neutrality of any sort, and no handy summary of the capital gains arguments.[1] The topic narrowly addressed is the effect on income tax complexity of differential treatment for capital gains and losses.

I have found this paper difficult to write. In part it is because pretty much all of the modest amount I have to say on the subject I have already said,[2] and it is bothersome, although hardly unknown, to borrow from oneself. But the main problem is that we plumb the depths of the obvious. Of course a special capital gain/loss taxing regime adds significantly to the complexity of an income tax system.

Recall what evolved in our tax law, prior to the 1986 legislation, as the rules of the capital gain/loss road.

First, the need for a sale or exchange, or for something treated as a sale or exchange. Retirement of a debt instrument is considered an exchange, from the viewpoint of the

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holder,[3] unless the issuer is a natural person, in which event it is not.[4] Cancellation of a lease, from the viewpoint of the compensated lessee, is treated as an exchange whether the lessor is a natural person or an unnatural one.[5]

Second, the need for a capital asset,[6] or for something which, while not a capital asset, is treated as one or at least as giving rise to gain that is treated as capital gain.[7] In fact, since the Code's capital asset definition is expansive, while some provisions deem to be capital gain what otherwise would or might be ordinary income,[8] others convert to ordinary income what otherwise would or might have been capital gain.[9]

Finally, the need for a long-term holding period, more than six months or more than one year or whatever, or the need for a provision that deems the relevant holding period requirement satisfied whether or not, in fact, it is.[10] Of course, there are provisions that go the other way and announce the holding period requirement has not been met, although the taxpayer has in fact held the property for the prescribed period.[11]

Over the decades, reams were written on the capital gain/loss taxing scheme and the enormous increase in simplicity that surely would accrue if only we could eliminate the special taxing regime. But none of us, I suspect, conceived that Congress would eliminate the long-term capital gain rate preference but retain the whole horrible technical structure--capital asset, section 1231(b) property, capital gain, capital loss, long-term, short-term, and all those nefarious sale/exchange/cancellation distinctions. In other words, Congress in 1986 found a way to eliminate the rate preference while preserving virtually all the complicating features of the special capital gain/loss taxing scheme.

Why did Congress do this? For one thing, Congress was promising restoration of a long-term capital gain rate preference incident to a feared increase in the top marginal tax rate. Retaining in the 1986 Code all that definitional baggage thus struck a blow for continuity; had it been removed, it would have had to be restored.[12] But this explanation does not foreclose another: Congress in 1986 comprehended the continuing need to curb the tax utility of capital losses in a world in which both gain and loss recognition remains elective. Extremely busy with other tax and non-tax things, Congress, it can be argued, kept the historic structure in place as a familiar way to deal with what we all know to be the goblin of our realization system, the cherry-picking problem. A taxpayer culling her portfolio to trigger $100,000 of net capital loss may be an object of sympathy if her portfolio retains no net appreciation, but she is nothing of the sort if she has selected bad from good and her net unrealized appreciation, to be extreme, is in untold millions. In the first case we should allow her full offset against ordinary income, but we do not[13] for lack currently of a satisfactory way to protect the revenue in the second case.

I propose to return in a few paragraphs to the cherry-picking problem and the tax law's capital loss limitation response, to consider whether a response better tailored to the problem with an attendant reduction in the complexity of the system (as well as an improvement in the perceived fairness of the system) might be formulated. But I did not want to abandon the gain side of the capital gain/loss taxing regime merely because, for the moment, Congress has abandoned the rate preference.

If the definitional rules remain intractably complex, as they do and will so long as the Code maintains the capital loss deduction limitation, is elimination of the capital gain rate preference independently Simplifying? Explicitly, has the 1986 Act's elimination of the section 1202 deduction (and equivalent corporate tax rate change in section 1201) yielded a discernible bounty in transactional simplification?

The Capital Gains Task Force of the ABA Section of Taxation, in a report prepared in 1989, concluded that the 1986 elimination of the capital gain rate preference, and consequent removal of the incentive to plan transactions to convert ordinary income into capital gain, has resulted in significant transactional simplification even though there has not been significant statutory simplification.[14] My own experience, while limited to that which is conveniently available to a poor schoolteacher, agrees with the Task Force's conclusion, and the experience of others I have asked seems in accord.[15] At this Conference I hope to broaden the base of testimony.

One of the asserted justifications for a long-term capital gain rate preference has been that "most capital gains are fictitious in that they merely reflect an inflation."[16] A different approach would resolve the perceived income measurement problem through some form of indexation, presumably the indexing of the basis of all or most long-held capital and quasi-capital assets for inflation occurring after a designated date. Treasury I offered this opportunity designating 1965. Representative Jenkins, in the Ways and Means Committee last year, proposed January 1, 1992. Presumably those proponents did not view indexation as significantly increasing the level of income tax complexity. Others, including Walter J. Blum in 1957[17] and Edwin S. Cohen in 1989,[18] have announced themselves of a quite different persuasion. At the conference on January 12, I hope we will generate some light and much heat.[19]

Finally, on the gain side, current law continues to offer the absolution of a zero tax rate to the investor who dies clutching a qualifying asset. Under section 1014, the line is not drawn between capital gain property and other property but rather between disqualified over ripe assets (section 691 IRD property and certain foreign investments) and everything else (mainly but by no means exclusively capital gain property).[20] On balance, the present rules are fairly simple--a zero rate of tax on all income would produce a very simple tax system--but it is common, indeed inevitable, to maintain investments and plan transactions to secure the benefit of a stepped-up basis as death.[21] It is certainly arguable that transactional complexity would be reduced were section 1014(a) repealed and transfers at death (or by lifetime gift) treated as recognition events. Opponents might well assert an increase in the overall level of tax complexity; who among the living, after all, knows the adjusted basis of the decedent's property measured immediately prior to death? Those who, like me, find the subject difficult to separate from the balance of the capital gain debate are encouraged to address it on January 12. I address it again, below, in the context of a proposed solution to the cherry picking problem.

It is now, I hope, appropriate to repair to that most nettlesome problem, the capital loss limitation. Assume at the outset that a capital gain rate preference will not reenter the law. Major reduction in statutory complexity--elimination from the Code of the capital

asset, sale or exchange, and holding period definitions for a start--is now at hand. All we need do is permit the deductibility of a loss to be determined without regard to the capital or not capital nature of the property sold. But what of the cherry-picking problem?

A. Any concern of loss limitation evaporates if we dump the realization requirement and annually force accrual of all property gains and losses. Professor David Shakow has argued the mechanics and merits of forced accrual with great insight and much conviction.[22] I am impressed but ultimately unpersuaded.[23]

B. If we do not dump the realization requirement and embrace unlimited annual accrual of property gains and losses. sensibly we ought to look in the opposite direction and reexamine the scope of our cherry-picking concern. A "taxpayer enjoying a sizable portfolio of readily marketable securities, many appreciated and others depreciated in value, absent an effective deduction limitation easily could and surely would retain gain assets and sell loss assets to offset ordinary income. But the opportunity, if not the desire, to cherry pick losses attenuates when the depreciated investment is not readily marketable. Consider, in that light, the following "mandatory mark to market regime"--the focus is on the "market"--to replace the capital loss limitation.

1. For all marketable property, we scrap the realization requirement and value the property at year-end, as if it were sold at that value on that day. Marketable property would be defined, expansively but not outlandishly, to include inter alia open-end mutual fund shares as well as readily tradeable securities, and otherwise nonmarketable rights, options, and convertible instruments the value of which derives, positively or negatively, in significant part from residual securities that are marketable.

2. The concept of a capital asset or gain or loss is expunged. Other deduction limitations are preserved, for example §469 and §267(a)(1),[24] and loss generated in a sale-leaseback transaction is disallowed currently and capitalized to the leasehold interest.

3. Gain is recognized on a gift of appreciated property. Section 1014 is repealed, gain and loss are recognized on the transfer of property by reason of death, and problems of liquidity are ameliorated through a generous but not lunatic expansion (well beyond the current six months) of section 6161(a)(1).

C. Arguably, there is a third choice, in a tax world stripped of the capital loss limitation, in addition to forced annual accrual of all property gains and losses on the one hand, and forced annual accrual of only marketable property gains and losses on the other hand. The realization rule would be fully preserved, but net realized losses on marketable property (and perhaps on some or all nonmarketable property)[25] dispositions would be deductible in any year only if and only to the extent such property disposition losses exceed the taxpayer's net unrealized marketable property gains measured at year-end. A taxpayer receiving dividend income ineligible for a section 243 deduction[26] would, in this third choice regime, treat that income as if it were gain recognized on a disposition of marketable property.[27] The remaining features of the mandatory mark-to-market regime, including elimination of any capital loss limitation, preservation of the limitations under §469 and

§267(a)(1) (perhaps expanded), and recognition of gain on gift and of gain and loss on death, also would be features of the third-choice regime.

When it was put forward in the spring of 1987 at the Invitational Conference on subchapter C, the third-choice proposal attracted some favorable comment and a criticism which seems to me persuasive. Under this proposal, the taxpayer has a strong incentive to isolate in a separate entity, or in the hands of a friendly offspring, marketable property investments deemed likely to appreciate in value. In this way the taxpayer, cherry-picking losses on other investments, need not offset the unrealized appreciation in the marketable securities he has placed in other hands. Thus, if adopted, the third-choice regime very likely would incorporate complicating attribution concepts and almost certainly would engender significant transactional complexity.

The mandatory mark-to-market regime, on the other hand, does not suffer from an equivalent infirmity. It does little good to place appreciating marketable property in entity or offspring hands if at year-end the holder must accrue and pay tax on the gain.[28]

All in all, to replace the capital loss limitation, I cast my own vote for plan B, the mandatory mark-to-market proposal, under which nonmarketable property gains can be deferred for a time, while losses are enjoyed but cannot be interminably deferred by gift and will not be avoided at death.

I look forward to the debate.

ENDNOTES

[1] Professor Walter J. Blum's seminal 1957 paper of that title, recently republished in Tax Notes (September 4, 1989), 1145, remains the starting place for thinking more broadly about preferential tax treatment for capital gains. In the ensuing decades, of course, countless thousands of pages have been published by tax professionals and academics and by economists of all persuasions. Of that which I have read, I do not understand most of it and disbelieve the larger part of the balance.

[2] The papers are: "Reexamining Subchapter C: An Overview and Some Modest Proposals to Stimulate Debate" (1987), reprinted in *A Report of the Invitational Conference on Subchapter C.* 39 (1988); and "Whatever Happened To Tax Simplification," *Record of the Association of the Bar of the City of New York* (1987): 765.

[3] Code § 1271(a)(1).

[4] Code § 1271(b)(1).

[5] Code § 1241.

[6] Code § 1221.

[7] Code § 1231.

[8] See, e.g., Code §§ 483//9d)(4), 1235, 1237, 1274(c)(3).

[9] See, e.g., Code §§ 1245, 1249, 1250, 1252, 1253, 1254, 1273(b)(3), 1274.

[10] See Code § 1235(a).

[11] See, e.g., Code § 1233(b) (certain short sales).

[12] The 1986 Act Conference Report, H.R. Rep. No. 99-841, 99th Cong., 2nd Sess. II-106 (September 18, 1986), explicitly states that the "current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if thee is a future tax rate increase." 1986 Code §1(j) will reinstitute the long-term capital gain rate preference (at 28 percent) if the maximum rate generally imposed on individuals is increased above 28 percent, and 1986 Code §1201(a) performs a similar service for corporations (at the 34 percent rate).

[13] Except $3,000 of capital loss offset under Code §1211.

[14]The Task Force (seven members) reached this determination by majority vote with one member noting an increase in planning for tax deferral through nonrecognition exchanges (a no doubt welcome confirmation that tax planning is not dead and tax planners are not likely to become extinct).

[15]While attesting to reduced concern with planning for capital gain, a number agreed with the Task Force members who found on the increase planning for tax deferral, and mentioned recent special effort to avoid the adverse impact of Code § 453A, a task Congress in the Revenue Reconciliation Act of 1989 has made a good deal more onerous.

[16]See Blum, supra n. 1, at 1151 (argument 19 for preferential treatment of capital gains).

[17]Id.

[18]Cohen, "The Pending Proposal to Index Capital Gains," Tax Notes (October 2, 1989), 103, reprinting Professor Cohen's address of September 23, 1989 to the New York State Bar Association Section of Taxation.

[19]Perhaps this will help to start the ball rolling. Surely it is perfectly clear, in the case of an investment that substantially appreciates in value over time, that the realization requirement in deterring the taxable event until the asset is disposed of reduces very substantially the effective tax burden relative to the burden that would be imposed were the investor required to accrue profit annually. In practical effect, then, while we tax an inflated nominal gain, through the realization requirement we tax that nominal gain at far less than the nominal tax rate. Of course, it is not perfect--what is--but in an imperfect world, why is it not an adequate "simplifying" offset?

[20]In general, a lifetime gift of Code § 1014(a) qualifying property is not a taxable event and shifts the gain to the donee, while a lifetime gift of Code § 1014(c) property generally is either a taxable event to the donor--see Code § 453B--or an invalid attempt at assignment of income.

[21]This was the genesis of the famous National Starch Code § 351 transaction, involving the issuance by a newly formed corporation of shares of a complexly tailored preferred stock. See Rev. Rul. 84-71, 1984-1 C.B. 106.

[22]Shaow, "Taxation Without Realization: A Proposal for Accrual Taxation," *U. Pa. L. Rev.*, 134 (1986): 1111.

[23]Testifying before a Congressional Committee on a tax reform proposal a decade ago, the late Converse Murdoch summed up his opposition in a sentence I thought wonderful then and find all the more compelling with the passage of time. "An old complexity," he announced, "is better than a new complexity, particularly if you are an old lawyer."

[24] The relevant relationships described in Code § 267(b), however, merit re-examination. For example, in Code § 267(b)(2) the reference to a more than 50 percent (in value) shareholder might be reset at a lower number.

[25] If you are persuaded that, essentially, the cherry-picking problem equates to the taxpayer's ability to cull marketable investments, in aid of reduced complexity you will not extend the new deduction limitation to any nonmarketable property losses. If, however, you believe the problem encompasses some nonmarketable property investments--for example, real estate--you may be willing to incur a measure of added complexity and announce that net realized losses on marketable property and real estate dispositions will be deductible in any year only if and only to the extent such property disposition losses exceed the taxpayer's net unrealized marketable property gains measured at year-end.

[26] An individual taxpayer receives no deduction benefit under Code § 243. If that provision were amended to limit its benefits to direct corporate investors, a reform that has been proposed by some and opposed by others, all dividends on portfolio stock investments would be ineligible for the Code § 243 deduction.

[27] To illustrate the significance of this income characterization, assume that during the taxable year Ms. A, on sales of marketable property, recognizes gains of $20,000 and losses of $120,000, or a net recognized loss on actual marketable property sales of $100,000. During the year Ms. A also receives salary income of $200,000 and dividend income of $75,000. At year-end the marketable securities owned by Ms. A, if sold on that date, would produce a net gain of $90,000. If dividend income is not treated as marketable property gain, under the proposal Ms. A is permitted to deduct currently against ordinary income $10,000 of her $100,000 net recognized loss on marketable property disposition, and the $90,000 balance of Ms. A's recognized loss is carried forward to the following year. If, however, Ms. A's $75,000 of dividend income is treated as marketable property gain, an additional $65,000 of her recognized loss is currently allowable and only the $25,000 balance of that loss is currently disallowed and carried forward to the following year.

[28] It would do some good if the holder were in a lower tax bracket, but taking account of the subchapter C double tax regime and the high Code § 11 burden, the generally flat rates of individual tax, and the Kiddie Tax, this is not currently a serious concern.

COMMENT ON "INCOME TAX COMPLEXITY: CAPITAL GAIN AND LOSS ISSUES"

JOHN S. NOLAN*

Martin Ginsburg--in his customary fascinating, incisive, and thorough manner--has identified all of the critical structural issues with respect to capital gains and losses. He does not, however, address critical economic efficiency and fairness considerations. These must be faced, because the role of capital gains in our income tax system is far more a matter of equity and economic policy than it is a problem of complexity. Furthermore, I am persuaded that we would achieve even simplification games under his favored plan B.

In these comments, I address the income tax system as it is traditionally applied in the United States, one that taxes nominal gains on sales of assets but only when realized. Norman Ture believes strongly that an income tax should tax amounts saved or the return on savings, but not both. Under this ideal model, capital gains in our structure should not be taxed at all because the property has been purchased with assets that have already been subject to income tax. I take a more parochial view that our progressive income tax structure has been indelibly shaped by fairness considerations to achieve some redistribution of wealth or, as some prefer to state it, to share the burdens of government on the basis of ability to pay. In this real world, when appreciation in the value of a taxpayer's assets is realized, it is taxed, even though in a broader sense that results in the double taxation of returns on savings.

Initially, I agree with Martin Ginsburg and others that we have achieved much transactional simplification by taxing capital gains as ordinary income, even though we have been left with the entire capital gain/loss complex statutory structure. I no longer spend sleepless nights worrying about whether particular transactions involve section 306 stock or

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Mr. Nolan's appointments include the following: chairman of the American Bar Association Section of Taxation (1981-82), member of the Advisory Group to the Commissioner of Internal Revenue (1967-68, 1983-84), vice-chairman of the ABA Section of Taxation (1965-68), and adjunct professor of Law at the Georgetown Law School (1955-59, 1971-78). Mr. Nolan was awarded the Alexander Hamilton Award, the Treasury Department's highest honor, on January 21, 1971.

collapsible corporations. And while sections 302 and 304 are still important, they are of far less application than they once were.

My first quarrel with Marty relates to indexation. He suggests that the benefit of deferral of tax on capital gains resulting from our realization requirement can be viewed as a simplifying offset to the detriment of taxing the inflation component of realized gains.

The report of the Capital Gains Task Force of the ABA Taxation Section recognized in early 1989 that indexation is vital to the correct measurement of income and recommended indexing the basis of all assets, subject to an interest charge for the deferral of tax. Indexation was recommended in *Blueprints of Basic Tax Reform*, issued by the Treasury Department in 1977; in Treasury I in 1984; by the sixty-ninth American Assembly at Arden House by a group of tax policy experts under the leadership of Joe Pechman in April 1985 under the title "Reforming and Simplifying the Federal Tax System"; and by many other tax policy experts. This correct measurement of income as a result of indexation, however, is just as important in measuring real losses incurred where there is no such deferral offset. In fact, the deferral of losses under the realization requirement in a theoretical sense exacerbates the mismeasurement of taxable income in an unindexed tax system. While the taxpayer is, theoretically, free to sell the asset to realize the loss, it is not always possible to sell loss property without forfeiting important economic or social values, such as preservation of a family business. In addition, market imperfections inhibit the sale of nonliquid assets.

Furthermore, even if real gain exists, an implicit interest charge as a simplifying offset to basis adjustments for inflation is not justified unless there is a reasonable correlation between the market interest rate and the rate of inflation used to adjust the basis of assets, which frequently does not exist. Furthermore, real gains will not accrue ratably over the life of the assets, which is the only basis on which we can compute an interest charge.

Indexation without an interest charge for deferral may be defended on economic incentive grounds. The effect of deferral is to gradually reduce the effective rate of tax as the holding period lengthens, providing greater benefits to more permanent investments, without the need for complex, multiple holding periods to achieve lower effective capital gain tax rates for long-lived investments. A 28-percent rate effectively falls to 23 percent after five years and to 11-percent after twenty-five years.

Indexation, however, is enormously complex, particularly with respect to pass-through entities, common in the United States because of our unintegrated corporate income tax. It also requires more than mere indexation of the basis of assets in order to account for debt. The adjustment to the liability side of the taxpayer's balance sheet to recognize that the taxpayer with debt benefits from inflation, except to the extent he or she reimburses the lender by a higher interest rate, is also inordinately complex. Treasury I attempted to deal with this problem by reducing the taxpayer's deduction for interest on debt by the inflation component. The lender's income would be reduced by the same amount. The Treasury I proposal was flawed, and no one has come forward since with a satisfactory alternative.

For these and other reasons, I am reluctantly persuaded that despite its essential merit in correctly measuring income or loss, indexation is too complex for our income tax system. A capital gain preference, particularly one with lower rates for longer holding periods, is a very rough and imperfect substitute for indexation. But a series of holding periods would itself create new complexities. We now see sprinkled throughout the Code and the regulations, in connection with provisions of narrow compass, exceedingly complex rules to attack transactions transferring ownership in form when in substance the benefits and burdens of ownership are retained. If the effective capital gain rate were successively lower for longer holding periods, parties would reverse these schemes. They will structure transactions that in substance transfer the benefits and burdens of ownership but do not do so in form until the last holding period has been reached.

Accordingly, purely from the standpoint of complexity, because we have achieved substantial transactional simplification by lower tax rates generally and have eliminated the capital gain preference, it may be concluded that we should not reintroduce a capital gain preference. But this is true only as long as the present low rates exist. More important, as stated earlier, is that considerations of fairness and economic efficiency far exceed the significance of the complexity problem in resolving this issue.

As to fairness, the present system of capital gains as ordinary income may be entirely appropriate to achieve reasonable progressivity in our current low rate structure, given that capital gains are realized to a much higher degree proportionately by higher income classes. As to economic efficiency, I defer to the economists on the question whether the stimulus of a lower capital gain rate is necessary or desirable to sustain higher levels of capital formation, business investment, and prosperity in the United States.

On the other hand, if reinstitution of a capital gain preference is to be accompanied by an increase in the top tax rate, it is arguable that there is a much stronger case for opposing it on the grounds of complexity. The present top effective rate of 28 percent makes a far greater overall contribution to simplification by reducing the otherwise irresistible pressures to create other preferences to ameliorate high rates of income tax.

To sum up, complexity considerations argue strongly against the capital gain preference if it can be obtained only at the price of a higher top effective rate. If, however, there is no such coupling, complexity is a consideration, but fairness and economic considerations are far more important in determining whether we should have a capital gains preference.

I have now strayed considerably from the thrust of Martin Ginsburg's paper. His paper assumes no capital gain preference is adopted. He then seeks to eliminate the complexities of the retained capital gain/loss <u>statutory</u> structure by dealing with the capital loss cherry-picking problem. Marty poses three alternatives and opts in favor of plan B: limited annual accrual of gains and losses on marketable property. He would mark to market at each year-end open-end mutual fund shares, readily tradable securities, and property interests, the value of which derives significantly from such marketable securities. This would permit abandonment of the concept of capital asset in the Code, and all the

statutory baggage that goes with it. This is so because, for the most part, the problem of the cherry-picking of losses would no longer exist.

Under Marty's preferred plan B, gains making gifts, and gains and losses at death, would be recognized. More liberal provisions for deferred payment of tax as to nonmarketable assets would be provided.

We are on common ground as to taxing gains on gifts and recognizing gains or losses at death, with liberal provisions for deferred payment of the tax. I testified in favor of that change in the 1979 hearings on the repeal of carryover basis. I think that change should be made in all events, irrespective of the general treatment of capital gains and losses. Except in the consumption income tax model, there is no justification in our income tax system for a zero rate of tax on gains at death. Taxing gains at death would achieve substantial transactional simplification, greater fairness, and increased economic efficiency by eliminating the most severe, existing lock-in effect.

But Marty's preference for annual accrual of gains and losses for marketable property only seems to me to present severe problems of economic efficiency and complexity. It would materially distort investment decisions to favor nonmarketable assets. It would create tremendous incentives to avoid the "tradability" of securities and to find ways to bury tradeable securities in non-tradable property interests. There would certainly be great controversy about this distinction.

Accordingly, I opt instead for Marty's plan C, whereby capital losses could be deducted in full to the extent they exceed net unrealized appreciation with respect to marketable property held by the taxpayer. Some pressure would exist, as under plan B, to avoid the marketable property classification of assets, but to a far lesser degree. I would extend this limitation on the allowance of losses to include losses on nonmarketable property. I see no particular reason to allow unrestricted realization of losses on nonmarketable property when the taxpayer has net unrealized appreciation in marketable property. This third solution was also endorsed in the sixty-ninth American Assembly at Arden House.

Martin Ginsburg notes that this third solution has been criticized because a taxpayer could isolate his or her marketable property in a separate entity or in the hands of a friendly offspring. I think we could handle the entity problem with our sophisticated attribution rules. This would add little overall complexity because we already apply such concepts for many other similar purposes in the Code.

If, as we both suggest, we tax gains on gifts, the offspring problem would be resolved. If we do not, the problem might call for a slight extension of the "kiddie tax" rationale, to take into account net unrealized appreciation of marketable property in the hands of minor descendants. If the taxpayer has made a complete gift of property to relatives who are not minors, we should not treat the taxpayer as having any interest in that unrealized appreciation. On the other hand, if the gift is not complete, the transfer would be ineffective for this purpose.

In any event, the limited added complexity from these rules to prevent abuse is far overshadowed by the advantages of simplification, fairness, and economic efficiency by allowing recognition of the taxpayer's losses except to the extent he or she has net unrealized appreciation in marketable property.

I hope I have added another dimension to the debate.

COMMENT ON "INCOME TAX COMPLEXITY: CAPITAL GAIN AND LOSS ISSUES"

NORMAN B. TURE*

Despite Marty Ginsburg's and Jack Nolan's preemptive strikes, I do intend to demonstrate to you once more that lawyers and accountants on the one hand and economists on the other march to different drummers.

Marty initiated his oral presentation with us this afternoon by indicating that he had interpreted his assignment as requiring his single-minded focus on simplification issues. And I would say notwithstanding his disclaimer that other issues will not intrude on his discussion, I think it is, or should be apparent--at this point agreeing with Jack Nolan--that it is virtually impossible, and indeed vacuous, to assess the simplification aspects of the law or proposals for its revision and ignore in that assessment what the likely impact of those proposals will be on the true substance of the law and on the way in which the law will change the incentives and disincentives confronting the people who must comply with the tax law.

Simplification as a stand-alone issue, it seems to me, is, if not sterile, very close thereto. Everybody has his own favorite example of the ultimate simplification scheme. I have yet to hear of one that improves on Professor Milton Friedman's two-line tax return: line 1, How much did you make last year? line 2, Send it in.

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Dr. Ture was a consultant to the Treasury Department on tax matters from 1962 to 1965, and was a member of task forces on taxation for Presidents Kennedy and Nixon. He was a staff member of the Joint Economic Committee of Congress from 1955 to 1961 and a member of the Treasury Department's tax analysis staff from 1951 to 1955. He has taught economics at George Washington University (1969-70, 1975-76), the Wharton School of Finance at the University of Pennsylvania (1968-69), and Illinois College (1947-50). Dr. Ture holds an M.A. and a Ph.D. in economics from the University of Chicago.

I think it is perhaps churlish of me--having been invited to participate in this splendid conference, having been wined and dined the other evening as part of that--to stand in front of you and tell you that I disregard or treat very lightly simplification issues per se and, at the very least, insist that all such issues and all such proposals should be evaluated in terms of something to which in tax policy I believe we should give a much higher priority.

In the present circumstances, given what's happened to the income tax over the last several years, it seems to me that top priority certainly must be assigned to questions of tax neutrality, questions of evaluating a body of the law and the thrust of the proposed changes therein in terms of whether the tax law will continue--somewhat less or somewhat more--to alter the relative prices and costs that, as taxpayers, we will confront in the market system.

It seems to me we ought to insist that the existing law be revised to minimize those distortions. Doing so, we are at the same moment, whether we recognize it or not, focusing on issues of efficiency, saving and investment, and economic growth. I will try to amplify on that very briefly in just a moment or two.

Professor Ginsburg has given us, I think, an enchanting exposition, both on paper and orally, of his solutions to problems that I think are misidentified. The fact of his solutions and his misidentification of problems and issues, I think, derives from the analytical context in which he and most tax policy people operate. It is a context provided us, though many of us are not aware of this, by Professor Henry Simons, who I believe has had more influence on the thinking about income taxes and about tax policy in general--I know this sounds like an extravagant statement, but I am prepared to back it up--than any other human being in history.

Now, having made so hyperbolic an assertion, let me just briefly spell out for you what Simons's paradigm was. It was that we should rely primarily--if not, indeed, exclusively--on an income tax, the base of which optimally would consist of an individual's consumption and the change in his or her net worth during the tax period. Notice there would be no taxes on corporate entities or any entities other than real live human beings.

Now, one might ask whether that definition that virtually everybody either explicitly or implicitly assumes to be correct indeed is the uniquely right definition of income for tax purposes. It was challenged. It was challenged vigorously by some of the outstanding economists of Henry Simons's day, in particular by Professor Irving Fisher at Yale University. Simons's response was simple and all the more elegant for its simplicity. He said, "There is one reason for an income tax. It is to reduce inequality in the distribution of income and wealth." And one might ask, Why should that be an objective of policy? "Because," Simons responded, "I, Henry C. Simons, regard inequality in the distribution of income and wealth as aesthetically repulsive and morally repugnant."

Well, not all of us share that view, and I will now attest that I find it beautiful and morally essential to have inequality in the distribution of income and wealth.

Simons insisted that his concept of income and all of the prescriptions that he offered for embodying it into an income tax law had a single purpose, to facilitate equalizing the distribution of income and wealth. He granted that if you were to assign another policy objective to taxation, his concept, the whole structure that he had erected, might very well collapse.

Well, it is in the context of this Simons vision of an income tax and its reasons for existence that we can identify as serious problems that are cast up by the existing tax treatment of capital gains and losses, the problem of accrual versus realization, and the cherry-picking problem that Professor Ginsburg has presented us.

Suppose we look at an alternative way of casting up an analytical context for examining and assessing tax provisions. Suppose we start with the observation that an income tax of essentially the basic structure that we now enjoy--or not, as the case may be--is inherently biased against saving and, therefore, capital formation and in favor of current consumption uses of current income. This bias can be represented algebraically or arithmetically, and shows that under an income tax of essentially this character, the tax has the effect of making it relatively more costly to use one's income for purposes of acquiring sources of future income than to use one's income for current consumption.

The question is: What social purpose is served by such a tax? Clearly, it is antisocial to bias us against saving and in favor of current consumption uses of our income. Simons, incidentally, recognized explicitly, repeatedly, and frequently that his tax prescriptions would, indeed, if implemented anywhere near fully, have the effect of socializing saving and capital formation, because, if fully implemented, there would be no impetus, no incentive for anyone to save and to invest. His response to that was: So be it. As far as he was concerned, the objective of equalizing the distribution of income and wealth was far more consequential, deserved much more of our attention, than any concerns about the efficiency with which the economy operated. His answer to this charge was: Well, let the state do the saving and investing.

For people who, particularly in the recent weeks, perceive the failure of statism, of collectivization of such decisions in the hands of the state, it seems to me Simons' prescriptions and their basis, conceptual and philosophic, require careful re-examination at this time.

Suppose that in lieu of the Simons approach we were dedicated to designing an income tax that was as nearly neutral as it could be, at least with respect to its impact on the choice between saving and consumption uses of current income. As Jack Nolan has indicated, what we would do under those circumstances is either to include in current taxable income the amount the taxpayer saves and exempt from tax all of the returns on that saving or to do the reverse. We would allow him to deduct from his current income for current income tax purposes all of his current saving but fully tax the gross proceeds representing the returns on that saving. Analytically, these are perfectly equivalent approaches.

Now notice what falls out if, indeed, we take one or the other of these approaches. We would look at the existing treatment of income that is saved, and we would detect a fundamental bias because we tax both the amount that is saved and all the returns thereon and tax them, incidentally, over and over and over again in one way or another. We would also identify the tax on capital gains as essentially equivalent, in the case of most assets, to a third tier or layer of tax on the identical income stream.

The tax on capital gains in the case of, say, common stocks, which represents a very substantial fraction of Marty's marketable assets, is essentially the same thing as currently taxing the undistributed earnings of corporate entities. But by virtue of the realization criterion, we defer that tax. That tax deferral and the benefit that follows therefrom should not be regarded, in the context I have just offered to you, as a benefit but as a modest abatement, a modest amelioration of the penalty of the third layer of tax on the returns on saving.

Therefore, that context suggests there certainly is no analytical impulse for accelerating for tax purposes the realization of capital gains. Anything that moves in that direction is counterproductive. For that very reason, it seems to me, Marty's prescription (A, B, or C) is counterproductive. It would, indeed, somewhat enhance the penalty tax that is represented by taxing capital gains.

By the same token, his concern about the cherry-picking of losses, it seems to me, ought to be viewed in the tax neutrality context for assessing the existing tax treatment. We do limit very severely the deductibility and offsetting of capital losses against other income. Notice what that does, whether we intend it as such or not. In doing so, we skew the probability distribution of tax gains or losses in the government's favor, the consequence of which is that we increase the risk-laden rate of discount or investment in capital assets. What social purpose is served by that? I hesitate to say. I know of none that I can identify for you.

Cherry-picking should be seen not as an evil, not as a failure of the tax to deal fairly and efficiently with particular situations in the law. Rather, it should be seen as only the most modest modification of a very substantial bias that the existing law exerts against savings and investment. By the same token, the general proposition that Marty puts before you (that is, marking to market for purposes of accelerating, in fact if not in theory, the realization of capital gains) has, it seems to me, the effect of intensifying, of enhancing the effective rate of this third-tier tax on capital gains.

In a policy context in which we are concerned about the alleged inadequacy of saving and of capital formation in this country, it seems to me that the principal way in which we ought to assess propositions of this sort is in terms of their likely effect on the cost of saving as compared to the cost of current consumption. I think it is inescapable that this sort of proposal must necessarily increase the cost of saving relative to the cost of current consumption.

Thank you very much.

Part II

The Conference Proceedings

WELCOMING COMMENTS--JANUARY 11, 1990

ARTHUR S. HOFFMAN*

Good morning, and welcome to the Invitational Conference on Reduction of Income Tax Complexity. It is under the joint sponsorship of the Tax Division and the American Bar Association's Tax Section.

We are fortunate to have a distinguished steering committee, which has been chaired by Stewart Dunn and Don Summa, representing the Section and the Division, respectively. The members of that committee are Dave Glickman, Dick Katcher, Ray Sommerfeld, Jay Starkman, Alvin Warren, and Don Wiese.

Our attendance is not only an expression of interest in the subject but also is a tribute to the members of that steering committee. Their reputations indicate to us that the conference is a dead-serious effort to accomplish a tangible result.

The conference manual is a collection of excellent papers by outstanding tax professionals. It is clear from those papers that we know, in heart and mind, that the legislative process cannot continue unabated. The tax law is being contorted to produce targeted revenue estimates. These days, policy and concern for administrability appear to be forsaken.

Charles McLure detects a "general fiscal craziness" and a "pervasive incoherence." He says that "tax policy has been put together badly because tax policy is, in the words of the old definition of a camel, a horse designed by a committee.

The great fear that we as tax professionals and as responsible citizens should have is that a large body of otherwise compliant taxpayers will say, "I can't understand how the law applies. I know that the IRS cannot enforce it. So the hell with it. I'll take whatever position is best for me, catch as catch can."

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Mr. Hoffman graduated from Columbia University (B.S., 1958) and New York University (J.D., 1963). He is a member of the American Institute of CPAs, the New York Society of CPAs, the American Bar Association, the New York Bar Association, and the Estate Planning Council of New York City.

Now, what good are revenue estimates in those circumstances? What terrible damage those circumstances would do to the indispensable factor of voluntary compliance.

This conference has been called because, as we see the weight and the density of new provisions and their regulations, it is apparent that the tiny priesthood of lawyers and accountants who are supposed to understand the law's arcane provisions is shrinking, and taxpayer compliance will follow--that is to say, will shrink.

Now, why is this happening? Charles McLure makes a highly perceptive point: One possible interpretation of events of the past decade is that the budget deficit, together with the reconciliation process, has opened up the tax-writing process as never before to the influence of non experts in the Congress--non experts who have little appreciation for the damage their seemingly well intentioned proposals can wreak on simplicity and no allegiance to a coherent and stable tax system.

I believe that interpretation is correct.

I wonder whether if genetic engineers were given freedom to act without policy constraints, they would create a no-legged, two-headed, four-armed human being. They might do so on the compelling theory that such a person would be more productive to society: For one thing, they could operate two computer terminals at one time. Unfortunately, absent policy constraints, certain recent tax legislation contains analogously monstrous characteristics and displays a similar lack of concern for the ultimate cost to society.

I see an equation between certain taxpayer and legislative behavior. It is quite proper to criticize a taxpayer who chooses to play the "audit lottery"--taking a position which is highly questionable and even frivolous--hoping he won't get caught. How degrading to the self-assessment system. I put it to you that it is more degrading of the system for those who draft tax laws to engage in the "legislative lottery"--sponsoring a provision while ignoring the impossibility of its application by taxpayers and the IRS--in the hope that this brutalization of tax policy will not be disclosed as such in hearings or by tax professionals.

What can we do? Tax professionals should stop being tolerant and resigned to seeing proposals that further complicate the law. We can be so understanding of their causation that we can contribute to the deterioration of the system by our silence.

Bob Shapiro says the following:

> Three major groups will have to lead this charge: professional tax advisors who deal more directly with the system in advising clients; the Treasury Department which, from its position as regulator and collector, is closest to the system; and Congress, which must be willing to participate and take a lead role.

He asks: "Why would Congress take the initiative? "Because," he says, "Complexity breeds a contempt for the system and the members." How true! And why should professional tax advisors and Treasury and all of us take initiatives against complexity? Because we are part of the system and are not free of the stigma.

Yet it is a repeated theme to say that "there is no public constituency for tax simplification" and none in the legislative process.

I appeal to the participants in this conference not to be defeatist. We know perfectly well what is the right thing to do. I believe that the public constituency for simplification is vast, but it needs the focus and articulation we can provide.

Over the last two years, subcommittees of the AICPA Tax Division have developed positions in areas of possible legislation, especially those areas where complexities existed or complexities were threatened to exist. The Executive Committee reviewed and adopted those positions early enough to be ready for Congressional hearings, and we testified in areas such as civil tax penalties, section 89, leveraged buyouts, corporate alternative minimum tax, and section 2036(c).

Incidentally, the civil tax penalty provisions were reformed and simplified in 1989 through a marvelously successful collegial process involving IRS, Treasury, the staff of the House Ways and Means Oversight Subcommittee, the ABA, the AICPA, and other organizations. The approach is a model for future attacks upon complexity.

In every area of testimony, we stressed how complexity damages the system, and we will again. We will be ready for submission of positions in the upcoming debates on, to mention a few, unrelated business income taxation of tax-exempt organizations, integration of taxation of corporations with shareholders, and estate and gift taxation.

In addition, we want to chip away at the complex provisions of the Code. We have a Subcommittee on Simplification chaired by Jay Starkman, who is on the task force of this conference. That subcommittee is assembling recommendations by the dozens. They are being designed to be a part of a comprehensive simplification act that, at least in principle, every Congressman we have spoken to would like to sponsor.

I want the participants to know that the resources of the Tax Division of the AICPA will be devoted to delivery of the message that develops out of this conference. It will be delivered to the Congress, to the media, and to the public.

Since these are opening remarks on our first day, I am not in a position to define our final message; but even this early in the morning, I know that we will say that tax laws should not be passed the way the papers in the conference manual describe as current practice. Let us dedicate ourselves to making this conference merely the first volley in the civil war of the nineties to produce a tax law which is more understandable and administrable and more worthy of respect.

I want to conclude with the following. It is my recommendation that we see what develops over these two days and that we express our views on whether we should declare ourselves charter members of an ad hoc group to promote the theme of this conference and whether we believe that the ABA Tax Section and AICPA Tax Division should maintain the steering committee to create events such as this conference, and perhaps, to organize us at times to rise up and smite some particularly ill conceived proposal.

Thank you very much.

KEYNOTE ADDRESS--JANUARY 11, 1990

LAWRENCE B. GIBBS*

It is a distinct honor and a personal pleasure for me to be able to offer my remarks today as your keynote speaker. I commend and congratulate the American Bar Association Taxation Section and the American Institute of Certified Public Accountants Tax Division for sponsoring this timely and important conference.

I know I express the feelings of all of us in thanking our co-chairmen, Don Summa and Stewart Dunn, and the other members of the steering committee for their hard work and leadership in preparing for and presenting this Invitational Conference on Reduction of Income Tax Complexity.

For the next two days, we will be exploring ways to reduce the complexity of our federal income tax system. It is relevant to our discussion to note that twelve years ago at the Airlie House here in the Washington area a similar conference was held to discuss the simplification of our tax laws. It is significant, I think, that twelve years later, the emphasis is on the reduction of tax complexity rather than on simplicity--how to make our tax system less complex, not how to make it simple.

This is an honest approach to a difficult problem. It is an approach that recognizes that our tax system--the law, its formulation, administration, and enforcement--is, in fact, inherently and necessarily complex. By its very nature, our tax law reflects the change and complexity of our economy and society. It reflects the incredible diversity and ingenuity that are our country's traditional hallmarks from Wall Street to Main Street.

As we begin our discussion, let us also recognize, and state the significance of the fact, that our tax law is legislated, administered, and enforced by our federal government --itself a system that has all of the complexities and inefficiencies that result from the checks and balances that were intentionally built into the system by our Founding Fathers.

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Mr. Gibbs graduated from Yale University (B.A. 1960) and University of Texas School of Law at Austin (J.D. 1963). He is a member of the American College of Tax Counsel, the American College of Probate Counsel, the American Law Institute, the Supreme Court of the United States, the American Bar Association, the Federal Bar Association, the Texas Bar Association, and the Dallas Bar Association.

The Legislative Branch, particularly the House of Representatives, was purposely designed to ensure that the views of each of the diverse and competing constituencies would be heard. The failure to adopt a parliamentary system -- thereby assuring the possibility of conflicting political and ideological philosophies between the executive and the legislative branches -- was intentional. The bifurcation of the formulation of tax policy and its administration was deliberate, as was the decision to give the Department of Justice and the courts the power to interpret and enforce (or withhold enforcement of) tax legislation and tax regulations.

But even allowing for the inherent complexity of our society, economy, and system of government, a feeling has developed that the tax law today has become overly complex to the point where there is concern whether the tax law continues to be administrable by the Internal Revenue Service, and no longer comprehensible by most taxpayers and many of their advisers.

Part of the complexity is attributable to the magnitude and the velocity of changes to the statute itself--an incredible 153 separate amendments to the Internal Revenue Code in the last fifteen years, an average of more than ten separate changes each year for the last decade and a half. Each year's changes are seemingly more voluminous than the last--ERTA, TEFRA, DEFRA, REA, TAMRA, COBRA, OBRA, and of course, TRA '86, just to mention a few.

And the changes do not affect only the so-called wealthy and sophisticated. For example, after the TRA '86, one of the most common errors on the 1040As and the 1040EZs--the simplest forms that are generally used by lower-income taxpayers--was the failure to claim the standard deduction, which for these taxpayers was the largest tax benefit that they received under TRA '86. Were the errors attributable to the complexity of the law or of the computation? No. The errors were attributable to TRA '86 change from the zero-bracket amount, which was built into the tax tables before 1986, to the standard deduction, which required a separate computation after the 1986 act. Or, as one of the top IRS taxpayer service assisters said to me one day: "The rules change so fast that on busy days during the filing season, I have real trouble remembering whether the rule I am explaining to the taxpayer on the telephone applies to last year's return, this year's return, or next year's return."

Quite apart from the magnitude and the velocity of the tax changes, the provisions themselves have often become incredibly complex. Our subjects for tomorrow--the at-risk rules, the passive activity loss provisions, employee benefits, and capital gains--literally boggle the mind. Provisions having wide application are becoming more and more complex--the alternative minimum tax and the accounting provisions in the general business area, the international tax rules, even the interest and penalty provisions that are applicable to individuals, corporations, and other taxpayers.

Again, the complexity is not limited to the wealthy and the sophisticated. Over the last three years, in attempting to determine why the IRS had such a low accuracy rate in answering questions about the deduction for personal exemptions (which every individual taxpayer can claim), I was astonished to learn that in order to give a technically correct

answer to a taxpayer's question about the personal exemption deduction, an IRS assister might be required to sort through some forty-two separate questions with the taxpayer.

I believe it is important for us therefore to focus on the impact of change and complexity in our tax law. Many in our audience today and tomorrow are members of the so-called tiny priesthood of lawyers and accountants who generally understand what our tax laws and our tax system is all about. The tax law change and complexity that we are going to discuss is, in my opinion, affecting the priesthood. I am frankly disturbed about the trend toward increasing specialization and the concomitant trend toward larger professional organizations among tax practitioners within the government as well as in the private sector. I am equally concerned about the prospect of a national court of tax appeals, driven in no small part by the concerns about the increasing complexity of our tax law. But frankly, I am most concerned about the plight of practitioners in communities and firms that are too small to permit specialization.

I think we should remember that the overwhelming majority of federal income tax returns are prepared by non-CPAs in relatively small firms. This takes on added significance when we realize the growing trend of taxpayers to rely on paid preparers to fill out their tax returns.

According to the IRS, almost 50 percent of individual filers now use a paid preparer, and the IRS suspects that the actual figure is even higher in the sense that many taxpayers rely on others--a family member or friend--to prepare their return without compensation.

If the Money article of last year was correct in suggesting that only a handful of accounting firms accurately prepare relatively simple individual tax returns, and if the IRS taxpayer service polls last year were correct that IRS employees give correct and complete answers no more than 65 percent of the time, what does that mean for non-CPAs and taxpayers in general?

Regardless of what it means, is the question important? I submit that it is important. Why? Because our tax system really does depend on the voluntary compliance of our taxpayers. In order to voluntarily comply, taxpayers must be both willing and able to comply. If, because of change and complexity, trained practitioners and the IRS have difficulty in understanding how to comply, do we really believe that relatively untrained taxpayers and less sophisticated practitioners will be better able to comply?

Perhaps a more telling point: If taxpayers believe that the law is so complex that not even tax lawyers and accountants or the IRS can get the right answer, are taxpayers going to be willing to comply?

Some say yes -- because of the economic and potential criminal sanctions applicable if a taxpayer fails to comply. I disagree. Although I believe that such sanctions are important, I do not believe that you can rely on the fear of sanctions to motivate 200 million taxpayers. Indeed, at some level of change and complexity, I believe it is both unfair and counterproductive to rely on sanctions to encourage compliance. This was certainly an important premise of the recent legislation to simplify and reduce the tax

penalty provisions.

And in any event, the tax gap studies by the Service suggest that after-the-fact compliance and enforcement efforts are irrelevant in the face of substantial noncompliance. That is, the tax gap studies indicate that even if you give the IRS all of the compliance resources that it can absorb, the IRS can collect on a cost-effective basis no more than about 35-40 percent of the net tax gap because the remainder is likely to be in such small amounts over so many taxpayers that it is simply not cost-effective for the IRS to collect it.

It is my opinion that for a variety of reasons most American taxpayers today voluntarily attempt to comply with their tax obligations. The real threat of change and complexity in our tax system is that they may so undermine the willingness and ability of a sufficiently large number of our taxpayers to voluntarily comply that it could substantially and adversely affect our tax system. And our tax system, let us remember, is currently raising in excess of $1 trillion annually, which is quite literally the price that we are paying for the standard of living that we enjoy today.

Will it happen? Will change and complexity lead to a substantial increase in noncompliance? I do not know, but the rising noncompliance rates during the recent tax shelter era should give us cause for concern. In this connection, the 1987 report on the ABA Commission on Taxpayer Compliance, which grew out of the 1983 Reston Conference on Compliance, recognizes that change and complexity are significant sources of noncompliance. The report urges Congress to address change and complexity "so that ignorance of or uncertainty about the law will become less important as a source of noncompliance."

In evaluating the risk that continued change and complexity may lead to substantial increase in noncompliance, remember that each one-percent change in the compliance rate involves an estimated loss or gain of $5.5 billion in annual tax revenue. My point is that some risks are so great that they should not be taken, and I believe this is one of them. This is therefore my basis for believing that we should properly be concerned about the impact of change and complexity on our tax system.

What can we do about change and complexity? I believe that our discussion during the next two days will provide a good start in developing answers to this important but difficult question. As with any problem, it seems that the best way to start is to determine the root causes of change and complexity in our tax law. Experience teaches us that we should not be surprised if there are many causes. I urge that in the process, we resist the temptation to lay blame or to look for quick fixes.

I believe that for the most part, we will find that the causes are not people problems but systemic problems. The background papers by Charles McLure, Buck Chapoton, Roscoe Egger, Bobby Shapiro, and Deborah Schenk do an excellent job in illuminating some of these systemic causes, not the least of which are the political, economic, and governmental processes that make up our tax system.

Although I concur with the sentiment expressed by some of our speakers that it is

likely to be difficult to develop a constituency for reduction of income tax complexity, I believe that the constituency can be developed if (1) the dangers of complexity can be explained to the public, (2) the causes can be fairly and comprehensively described, and (3) realistic, reasonable solutions can be proposed.

I do not suggest that the task will be easy, but I do suggest that the task will be no more formidable than was that of educating and mobilizing the American public about the importance of reducing the federal budget deficit.

Another cause for my optimism lies in the fact that each of several of our speakers proposes that different parts of our tax system should take the lead in finding ways to reduce income tax complexity. Bob Shapiro suggests that the leadership should be in the Joint Committee on Taxation and its staff. Buck Chapoton suggests that the Treasury Department through the Office of the Assistant Secretary (Tax Policy) should take the lead. Roscoe Egger suggests that the Internal Revenue Service should play a key leadership role.

My own opinion is that because of the number and types of causes of the problem, it will be necessary to have substantial leadership and participation from both the public and private sectors to identify causes and develop solutions. Certainly the nature of our system of government is such that a collegial, if not consensual, approach will be necessary. In this regard, I wish to highlight a significant difference between the agenda for this conference and that of the Airlie House Conference, namely, the increased emphasis at this conference on possible changes in the processes by which the tax law is legislated, administered, and enforced, as well as the more traditional discussion of structural reform of the Code itself. Ultimately, it seems to me likely that Congress, its tax writing committees and staffs, the Office of Management and Budget, Treasury and IRS, the Department of Justice and the courts, state and foreign governments, professional and taxpayer groups, the media, and others will have to be involved in some fashion if we are to successfully address the problem and the challenge of reducing income tax complexity.

I am encouraged that the breadth of this participation has already begun. Increasingly, we hear from members and staff of Congress that reduction of income tax complexity is beginning to make an appearance on their radar screens--validation, perhaps, that media and constituent mail are increasingly targeting Congress for the growing complexity of tax forms and instructions. Treasury and the IRS have already begun to address complexity issues in the regulations and administrative process, and I was delighted to learn that the IRS recently has adopted the reduction of income tax complexity as one of its specific objectives in its strategic business plan. I think it was constructive that the IRS Research Conference explored this issue; I also was delighted to learn that the American College of Tax Counsel, in conjunction with the Southern Federal Tax Institute, has taken a substantial step to fund a major study in this area.

Another reason for my optimism is that history validates the impact that conferences like this can have. Looking back, I honestly believe that the Reston Conference on Compliance in 1983 was one of the most significant factors of the last decade in addressing the causes and solutions of the noncompliance problem. And as I mentioned earlier, I am concerned that change and complexity may well become the noncompliance project for the

1990s. In short, I am hopeful that over the next several days we can make a difference, even if it is simply to take the first steps of that thousand-mile journey.

Continuing in the Chinese vein, it seems to me that we do indeed live in interesting times. With the events in Eastern Europe last year, I think all of us have been impressed by how quickly major changes can and do occur in our world today. Why not, therefore, a change designed to reduce change and complexity in our tax system? Would such a change be any more remarkable than the other changes that are occurring around us?

To conclude my opening remarks, I wish to look beyond the discussion of the next two days. Some already are understandably questioning what we and this conference are likely to accomplish. Will our concerns and our discussion simply be "sound and fury, signifying nothing," to borrow Shakespeare's phrase, or will they lead to something more lasting? The difficulty in reducing income tax complexity and the substantial time and talents of those who previously have attempted to do so suggest the wisdom of underpromising in hopes of overperforming.

And yet, the importance of reducing tax complexity and the risks of failing to do so suggest that we should be bolder and more assertive. I therefore urge each of us over the next two days to be energetic and provocative as we begin to explore the causes of tax complexity and seek solutions for reducing it. I further call upon the ABA Taxation Section and the AICPA Tax Division, the sponsors of our conference, to take up where we leave off tomorrow and to provide the continuing leadership for finding ways to bring about a meaningful, lasting reduction of income tax complexity.

And as we approach these challenges, I think we have something going for us that we should neither forget nor underestimate. Unlike most of the countries around the world, the United States made a voluntary decision to adopt a federal income tax. It was not imposed by a conquering nation, nor exacted by the government. It was ratified by the American people almost eighty years ago.

Over the last eighty years, there have been many challenges to our income tax system. We have always had the will and developed the leadership to respond to these challenges to make our tax system grow and prosper. I believe it is important that we rekindle the ingenuity and energy to do it again. It will not be easy. It will take patience and persistence. I look forward to our discussion today and tomorrow.

Sources of Tax Complexity:
The Budget Process

Session 1: Thursday Morning, January 11, 1990

Presenter:	Charles E. McLure, Jr.
Moderator:	Alvin C. Warren
Panelists:	David F. Bradford
	David H. Brockway*

The purpose of this session was to focus on the role of the budget process in contributing to tax complexity. Charles E. McLure, Jr.[1] began the session by suggesting that the interaction between the budget process and complexity in the tax law is a relatively recent phenomenon, having its roots in the Budget Act of 1974, the end of easy expansion of federal spending, the 1981 tax cut, presidential promises of "no new taxes," and the budget limitations imposed by the Gramm-Ruddman-Hollings Act.

These forces have led to tax writing that is more motivated by meeting revenue targets than by careful consideration of tax policy, by reliance on politically innocuous but complex "loophole closers," by frequent use of transition rules, and by too little attention to technical details when legislation is written. In spite of these complexity-increasing forces, the new budget process has led to greater recognition of the costs associated with tax expenditures.

Professor McLure offered three proposals to improve the tax legislation process. The first is to meet budget targets by adjusting tax rates rather than adjusting the tax base. He acknowledged that there are problems associated with this approach but believed the outcome would result in less complexity than under the current system. Alternatively, he proposed a more radical approach, in which only basic rules would be written by Congress, with greater responsibility for writing regulations delegated to the Treasury Department. This proposal would reduce the power of the Congress to "fine tune" legislation to satisfy special interest groups. A third proposal would be to do nothing, under the assumption that the underlying problem is the federal budget deficit, not the budget process.

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*Charles E. McLure, Jr. is a Senior Fellow at the Hoover Institution at Stanford University.

Alvin C. Warren is Professor of Law at Harvard Law School.

David F. Bradford is Professor of Economics and Public Affairs at Princeton University.

David H. Brockway is a tax partner in the New York and Washington, D.C. offices of Dewey, Ballantine, Bushby, Palmer & Wood and former Chief of Staff of the Joint Committee on Taxation of the U.S. Congress.

Professor David Bradford[2] concluded, however, that there is no compelling link between the annual budget cycle and our increasingly complex tax law. Instead, he placed blame on the "inadequacy of the budget language"; that is, a constraint that requires increased revenue without changing rate schedules ("no new taxes") leads to complex tax rules to accomplish what could have been produced with a simple change in nominal rates. In particular, he noted that tax expenditures can be manipulated to avoid the appearance of a tax increase.

Professor Bradford called for a budgetary language with clear, economic content. Because he is pessimistic about achieving such "radical reform of the language," he offered an alternative suggestion: to move toward "a system in which the inadequacies of the income definition . . . will do less harm and in which the complexity will be concentrated among fewer taxpayers." Two specific suggestions were to tax business and capital income at a uniform rate and to tax both forms of income at source. The effect of these two changes would be to reduce the significance of legal form and reduce the number of taxpayers who would have to deal with complex rules.

The second panelist, David Brockway,[3] asserted that the problem is with the people attending the conference, who, in their various roles, represent individuals who do not want simplification if it hurts them or their clients. Moreover, even tax reformers put their desire for equity or for increased saving and investment above the goal of simplification. To achieve simplification, all parties must be willing to compromise some of their substantive desires.

Mr. Brockway disagreed with Professor McLure that the budget process has a great deal to do with increasing tax law complexity. Indeed, he believes there has been no rigorous analysis of the overall effect of the relationship between the budget process and tax legislation. He rejected both of Professor McLure's positive proposals (limiting the role of Congress in writing tax law and a "rates only" approach to achieving revenue neutrality) as unrealistic and unsupported by any evidence that they would result in simplification of the tax law. Simplification can be achieved only when it is the principal goal, not when the principal goal is some substantial political objective.

Following the general remarks by the panelists, Professor Warren noted that although Professor Bradford's proposal to tax income at a uniform rate at source would certainly simplify the tax law, Mr. Brockway would characterize this plan as a perfect example of the conflict between simplicity and other goals such as progressivity. Professor Bradford pointed out that he had proposed taxing business and capital income--not labor income--at a uniform rate.

Comments and questions were then offered from the floor. One participant stated his belief that complexity has increased for the vast majority of individual taxpayers. Further, he blamed some of the increased complexity on the fact that legislators are more interested in revenue neutrality than they are in well-thought-out proposals to change the tax law. Mr. Brockway responded that the greatest resistance to simplification comes from individual taxpayers who do not want simplification if it costs them more in taxes. He asserted that in the aggregate, filing tax returns is simpler for individuals because of changes such as the 2 percent floor on miscellaneous deductions.

Another participant wondered if a change in campaign finance laws would lead to greater simplicity in the law. He noted that this solution seems more viable than some of Professor McLure's proposals.

It was pointed out that substantive tax reform is not necessarily inconsistent with simplicity. For example, charitable contributions could be limited to basis, and installment sales treatment eliminated. Mr. Brockway agreed that both suggestions would be good tax policy and would lead to simplification. Referring to the previous comment, he doubted that reforming campaign contribution laws would lead to much simplification because eliminating tax preferences is never popular.

One participant asked Professor Bradford if his idea of collecting tax at a uniform rate at the source might produce distortions and inequities because of the large amount of interest income that flows to tax exempt organizations and to foreigners. Professor Bradford agreed that these questions would have to be addressed.

Another participant noted that Mr. Brockway's comments that substantive changes lead to complexity is typical of statements from the Joint Committee; that is, there is no concern for simplicity or ease of compliance. Instead, there seems to be an obsession with closing loopholes. Mr. Brockway responded that political pressures prevent simplification from being the highest priority. "I just think you are misunderstanding what the political process is about," he stated.

The final question came from a participant who was skeptical that delegating tax writing authority to the Treasury Department would result in simplification. Audience response indicated that many shared his opinion. Professor McLure admitted it is not a definitive answer but rather a proposal for discussion.

A final exchange between Professors McLure and Bradford concerned the latter's proposal to treat tax expenditures and "expenditure expenditures" in the same way in the budget process. Professor McLure noted that the conference is concerned with <u>tax</u> complexity, and such a proposal would clutter up the tax law "with things that could better be done in the budget." Professor Bradford responded that distinguishing a tax from an expenditure does not do away with complexity as a matter of substance.

FOOTNOTES

[1] Professor McLure's Conference Paper is reproduced in Part I (A-1).

[2] Professor Bradford's Conference Paper is reproduced in Part I (B-1).

[3] Mr. Brockway's comments are reproduced in Part I (C-1).

The Role of the Treasury Department in Reducing Tax Complexity

Session 2: Thursday Morning, January 11, 1990

Presenter: John E. Chapoton
Moderator: David G. Glickman
Panelists: Frederic W. Hickman
Donald C. Lubick*

The purpose of this session was to focus on the Treasury Department's role in reducing tax complexity. The moderator, David G. Glickman, noted that the speaker and panelists, each a former Assistant Secretary for Tax Policy, were well qualified to discuss this subject.

John Chapoton[1] began the session by stating that his goal was to present some specific "real world" solutions that he believes can be implemented, albeit with difficulty. He first classified levels of complexity by taxpayer type. Level 1 is experienced by taxpayers who prepare the simplest tax returns. They do not itemize deductions, and their transactions are generally uncomplicated. Mr. Chapoton asserted that tax compliance has been simplified for level 1 taxpayers. Level 2 taxpayers itemize deductions and may have some complex investments or personal circumstances (such as divorce). These taxpayers engage in little or no tax planning but probably need professional help to prepare their returns. Level 3 taxpayers are the most sophisticated. They include businesses, and they engage in extensive tax planning. These taxpayers require professional advice in planning and accounting for their transactions.

Mr. Chapoton stated his belief that the causes of complexity are the frequency of tax legislation, the speed of the legislative process, and the fact that much legislation is revenue-driven. Furthermore, there is no serious constituency in the legislative process for simplification. His conclusion was that it is critical to fix responsibility and accountability for complexity in the Office of Tax Policy at the Treasury Department with the Assistant Secretary for Tax Policy. Mr. Chapoton selected this office because it is somewhat more removed from the political process than the tax writing staffs, it initiates most tax legislation, it has a great deal of independence, and it works closely with the IRS in solving complexity problems. The Assistant Secretary of Tax Policy would therefore have the best chance of building a constituency for simplification.

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*John E. Chapoton, Frederic W. Hickman, and Donald C. Lubick all have served as Assistant Secretary of the Treasury for Tax Policy. Mr. Chapoton is now a partner with the law firm of Vinson & Elkins in Washington, D.C.; Mr. Hickman is a senior partner with the law firm of Hopkins & Sutter in Chicago; and Mr. Lubick is a partner in the firm of Hodgson, Russ, Andrews, Woods & Goodyear in Washington, D.C. David G. Glickman is the Managing Director of the Washington, D.C. office of the Dallas law firm Johnson & Gibbs.

If Mr. Chapoton's suggestion were accepted, he would have the Assistant Secretary designate a "simplification czar" who would engage in hypothetical simplification proposals involving certain areas of the Code. The purpose of this effort would be to demonstrate that meaningful simplification can be accomplished and to develop techniques to accomplish it. He argued this would give simplification intellectual credibility in the Office of Tax Policy and should help create a constituency for simplification in that office. One goal should be to protect level 2 taxpayers from rules that really are aimed at level 3 taxpayers. Another goal should be to provide sufficient certainty at reasonable cost for Level 3 taxpayers.

A specific technique suggested by Mr. Chapoton is to have more "dollar thresholds" built into the law to reduce the number of taxpayers who have to worry about provisions. Another is to have "gross income thresholds" under which certain taxpayers do not have to worry about particular provisions. In drafting provisions, exceptions should all be in one place so that some taxpayers can easily determine that they are unaffected. Finally, he endorsed "horizontal drafting," suggested in 1979 by Ward Hussey. Under this technique, the same concept applies across-the-board to a number of Code provisions. For example, this technique could be applied to the various constructive ownership rules.

In summing up, Mr. Chapoton emphasized that the simplification director he proposes should be a major player in any legislative proposals put forward by the Office of Tax Policy. Further, all proposals sent forward from the office should be drafted in legislative language. Finally, the IRS should have a counterpart to the simplification director, with similar authority to deal with complexity problems in the regulations.

The first panelist, Frederic Hickman,[2] noted that several conditions at the Treasury Department would limit and shape any effort to do the things suggested by Mr. Chapoton. The first of these is the fact that the Treasury Department staff are intelligent but also inexperienced. He endorsed the view, expressed elsewhere, that while the veteran lawyer will deliberately decide not to draft against every contingency he can foresee, the inexperienced lawyer does not have the judgment or the self-confidence to know when to stop elaborating. He emphasized that in endorsing that view he was not complaining, but only reporting on an unavoidable condition that must be taken into account.

The second limiting fact is what Mr. Hickman referred to as a "theological commitment" to the Haig-Simons definition of income, a definition that Professor Simons intended as an ideal standard, not as a definition to be enacted. Mr. Hickman asserted that good tax policy requires frequent departures from the Haig-Simons ideal.

Given these limiting factors, Mr. Hickman had four comments regarding Mr. Chapoton's proposals. First, he noted that Mr. Chapoton's proposed "simplification czar" would have to be the Assistant Secretary of Treasury himself in order to have the capability to do the job. Second, he noted that although it is a useful idea for the Office of Tax Policy to be held "publicly accountable" for simplification, the Joint Committee is much for responsible for legislation and there can be no real simplification unless it is an enthusiastic partner in the effort. Third, horizontal drafting is a useful technique, but it is not practical in the near term to redraft the Internal Revenue Code. Finally, Mr. Hickman stated that

his one disagreement with Mr. Chapoton's paper is with its lack of emphasis on the role of regulations. This is one area in which the Treasury Department can have an impact on simplification without "endless political compromises."

The second panelist, Donald Lubick,[3] agreed with Mr. Chapoton that the most serious complexity problems are faced by level 3 taxpayers. However, the number of taxpayers in this group is probably smaller than it once was.

Mr. Lubick disagreed that a tax simplification czar would solve the problem. He believed it would not be wise to "take any of the heat off Joint Tax or off Ways and Means or Senate Finance staffs." In fact, he stated that the staffs deserve primary responsibility for several of our most complex sets of rules, including section 89 and the pension rules. Further, he noted that the Office of Tax Policy is not independent of Bush administration pressure and may be obsessed with the "adoption of intricate devices to keep waterproof the legislative dikes." In short, Mr. Lubick asserted that simplification must be a high priority for the Assistant Secretary of Tax Policy as well as the Joint Committee and the Senate Finance and Ways and Means chiefs of staff.

Specific projects such as those proposed by Mr. Chapoton should be funded by Office of Tax Policy contract money. These projects should include alumni of the Treasury and staffs with practical experience.

The moderator, David G. Glickman, then opened the floor for comments and questions. The first came from a participant who stated his belief that the proposals presented would not be enough. He recalled the experience of the Office of Industrial Economics, which in 1971 was given authority to develop and implement the ADR system. That office was unable to deal with the various pressures brought to bear on it and finally ceased to function. What is needed is broad commitment, not just from the Treasury Department but from the Office of Management and Budget, by the chairmen of the Ways and Means and Finance Committees, by the ranking minority members of these committees, and by the leadership of the House and Senate.

Another participant endorsed the notion of horizontal drafting, especially with regard to elective provisions. These rules could be reduced to a series of uniform rules without conflicting with tax policy or revenue objectives.

A third participant noted the need for attention within the Treasury Department to the regulatory process. In particular, the speaker called on the Treasury Department to provide guidelines for future regulations.

Further, on the subject of regulations, a participant described a New York State Bar Association project to redraft the section 752 regulations. This group of experienced attorneys succeeded in reducing these regulations from sixty-two to fourteen pages and intends to undertake further projects.

A former Treasury Department staff member supported Mr. Hickman's observation that there is a single-minded pursuit of a "correct" definition of income and that pursuit

may add complexity to the law. This is particularly true when the complexity also leads to increased revenues.

Another participant stated that progress toward simplification is already occurring and that new IRS Commissioner Fred Goldberg is a "simplification czar." He also noted that making simplification changes in groups or pairs may work by achieving a sort of "rough justice" between winners and losers. Finally, he challenged the premise of the speakers that leadership for simplification should come from the Treasury Department and asserted that it should come instead from those who have to administer the law: the IRS.

A requirement that tax bills include not only an estimate of revenue effects but also a statement of the effect on complexity was suggested by another participant. A uniform measure (such as cost per taxpayer to comply) should be developed.

Another participant complained that too little attention is paid to the needs of practitioners in small firms with small clients. The regulations should be oriented toward these practitioners rather than to those who represent the largest clients.

The final comment came from a college professor who supported Mr. Hickman's position that the Haig-Simons income definition is a worthwhile goal but that pursuit of this goal often leads to complex compromises and sometimes to confusion.

Mr. Glickman then called on the three panelists for final comments. Mr. Chapoton reiterated his position that we need to fix responsibility for complexity not to diffuse it. Mr. Hickman agreed with several participants who criticized Mr. Chapoton's lack of emphasis on regulations. He noted this is one area in which the Treasury can make progress, and he applauded Commissioner Goldberg's efforts. Mr. Lubick had the last word. He maintained his position that all responsibility for simplicity cannot be with the Treasury Department.

ENDNOTES

[1] Mr. Chapoton's Conference Paper is reproduced in Part I (D-1).

[2] Mr. Hickman's comments are reproduced in Part I (E-1).

[3] Mr. Lubick's comments are reproduced in Part I (F-1).

LUNCHEON ADDRESS--JANUARY 11, 1990

KENNETH W. GIDEON*

Last night at dinner, I warned Stewart Dunn that he might choose to introduce me after I spoke, after he has had an opportunity to assess whether I would be allowed to keep my "Simplify" button and be considered a simplifier in good standing. Indeed, some might consider the idea of an assistant secretary for tax policy supporting simplification as an oxymoronic notion, given the frequency with which I and my recent predecessors--and Buck, that includes you--have advocated changes in the tax law.

Most members of the tax community take it as axiomatic that our lives would be simpler if we'd simply leave the Code alone for a while. With time, practitioners and the public would learn about the new provisions, guidance would be issued to resolve ambiguities, and predictability would improve for both taxpayers and the government. While there is a great deal to be said for stability, both in terms of economic efficiency and in reducing our collective anxiety in confronting the seemingly ceaseless train of tax law changes, that stability is likely to elude us for some time to come.

Our federal budget deficit is an unavoidable if unpleasant reality. While I can join sincerely in our common chorus of regret that tax policy is currently and has for some time been driven by budgetary constraints, I must tell you quite frankly that I do not challenge the primacy of budgetary policy, and indeed I support it. Given the adverse impact of the deficit on investment and savings, getting federal spending under control must remain, at least for a while longer, our primary objective. Would we have better tax policy without current budget constraints? Sure, just as we could have more investment in transportation infrastructure, more environmental initiatives, more low-income housing, or your favorite outlay.

Budget-driven tax policy may not be--certainly, is not--ideal. But as long as our political consensus remains--as I think it should--that we must reduce the federal deficit, it is likely that the tax code will be pressed into service to achieve that end. This reality, which I urge each of you to accept if you really hope to focus on attainable simplification,

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*Kenneth W. Gideon was confirmed by the U.S. Senate as Assistant Secretary of the Treasury for Tax Policy on June 8, 1989, and appointed by President Bush on June 9. As Assistant Secretary for Tax Policy, Mr. Gideon serves as the chief Treasury spokesman and adviser to the Secretary in the formulation and execution of domestic and international tax policies and programs.

Prior to his nomination to the Assistant Secretary post, Mr. Gideon was a partner with the law firm of Fried, Frank, Harris, Shriver, and Jacobson in Washington, D.C. He served as Chief Counsel for the Internal Revenue Service, from 1981 to 1983. Mr. Gideon graduated from Harvard University (B.A. 1968) and Yale Law School (J.D. 1971).

means that simplification of the law, which will result in significant revenue loss, simply cannot be enacted unless revenue offsets are provided. Ideally, those offsets arise within the same simplification project, thereby increasing the likelihood that those who benefit from the simplification will also bear the revenue burden of the offset. Indeed, when simplification results in a significant shift in the burden of taxation, only the winners are apt to regard the proposal as improving the law. The losers can be counted on to denounce it, as usually being unfair, inefficient, bad tax policy, and yes, complex.

Which brings me to one of the more interesting paradoxes of my experience at the Treasury. Proponents of simplification almost invariably bemoan the fact that the proposed simplification loses money and hence--though desirable--runs afoul of the great budgetary jabberwock. My difficulty with these presentations is there does not appear to me to be any necessary relationship between simplification and revenue loss. Indeed, if the tax code is amended to delete a deduction formerly permitted, that change not only simplifies the Code but also usually raises revenue.

Now I don't mean to advocate the other extreme, that only revenue-enhancing simplification is desirable, but simply to note that simplifying changes come in both revenue-gaining and revenue-losing flavors and that there seems to be no reason why the two cannot be packaged to avoid budgetary cost and thereby attain overall simplification. Indeed, I simply don't believe that the political process will often decide that revenue-reducing simplifications are sufficiently desirable to take precedence over other competing claims for the same funds in the federal budget.

But neutral or near-neutral simplifications are attainable. Indeed, the 1989 Act contains provisions on both the alternative minimum tax and penalties, and these must be regarded as significant simplifications. Making these kinds of changes happen requires a willingness to accept trade-offs, balancing revenue-gaining and revenue-losing simplifications and balancing simplicity, fairness, and effectiveness.

Now I have heard the remark attributed to my new deputy Mike Graetz that fairness and simplicity are opposite ends of the same seesaw. Rougher-cut rules are clearly simpler, but that simplicity often comes at the price of ignoring reasonable claims for relief. There remains the significant political question as to whether the relatively low purr that emanates from those who benefit from reduced complexity will be louder than the bellows of the gored oxen.

That brings me to the final observation on simplicity that I want to make on the legislative process. I believe that fairness and good policy concerns are more important than simplicity on large-scale policy issues, which by their very nature are important and affect many taxpayers. In our current capital gains debate, for example, inflation indexing is clearly complex and administratively burdensome. I simply do not believe, however, that any of us is prepared to rule it out as a policy option simply because it is complex, although that complexity may well give us reason to pause.

On the other hand, it seems to me that complexity concerns are relatively more important when considering relatively minor or narrow issues. Indeed, many of our

problems of complexity derive from the sheer volume of little rules enacted to take care of this or that minor problem. Individually, these rules almost never appear invidious, but if we enact eighty special rules in a bill, the entire tax community must become familiar with all of them, not just the intended beneficiaries or targets.

Now I freely admit that these complications arise sometimes from overdeveloped staff concern about potential abuse as well as taxpayer lobbying for advantageous special rules. The problem is one of balance. While I don't believe that swearing off broad-based tax legislation is either feasible or even necessarily desirable, the development of a political constituency that could be counted on to oppose complicated small changes of both kinds could be a beneficial development. It will, however, require substantial wisdom, discipline, and patience to teach the gored ox to purr.

Progress in the legislative area toward simplification requires what is often an unattainable political consensus. In the area of Treasury regulations, however, the issue is somewhat more manageable. A commissioner and an assistant secretary committed to simplification can at least attempt to make it happen, and Fred and I are trying. In general our approach--as you will discern in projects soon to be published--has been to adopt the simplification philosophy that I think underlies our successful legislative simplification efforts.

First, while we attempt to resolve regulatory issues without primary focus on revenue concerns, we simply cannot adopt interpretations that would defeat the revenue objective of the enacting Congress. Second, within that general constraint, however, we have opted for simpler, less complex alternatives over complex options. In doing so, we have attempted to make rough cuts that do not unduly favor either the government or the taxpayer, but that will produce simpler, and we hope, more predictable results for both.

There is no particular formula for obtaining these objectives. In some cases, the adoption of a relatively more stringent basic rule allows the paring away of complicated provisions that would otherwise be required to prevent abuses. We recognize also that shorter is not always better. A regulation that fails to answer basic questions and thereby fosters uncertainty about frequently recurring and important issues is not in any true sense simplifying. Nevertheless, we are asking ourselves as we go through the process whether we really need this or that special rule.

In short, we have heard you, and we are taking your expressed desires to heart. The reaction to these projects when they are published--and I really don't anticipate that you'll have much difficulty discerning which ones I am referring to when you read them--will be an important test of the priority that the tax community really places on simplification. The rules will be simpler, but they will be more rough-cut. If they really are better for that reason, groups like this one must lend them public support. We know we will hear from those who want special relief and its attendant complications. The simplification constituency must also make itself heard in that process.

Tax Administration Considerations in the Development of Tax Policy

Session 3: Thursday Afternoon, January 11, 1990

Presenter:	Roscoe L. Egger, Jr.
Moderator:	Don J. Summa
Panelists:	William F. Nelson
	Jennie S. Stathis*

The purpose of this session was to focus on the role of tax administration in the development of tax policy. Roscoe Egger[1] began by noting that the Tax Reform Act of 1986 was once dubbed "tax reform for fairness, simplicity, and economic growth." The effort to achieve simplicity fell quite short. He then discussed the role of Congress, the Treasury, and the IRS in contributing to this problem.

Prior to 1962 tax legislation occurred at a more orderly pace, with ample time for hearings and revision. Since then, hearings have been held on "concepts without the benefit of legislative language," and the entire process has been characterized by haste. Congress alone is not responsible for this change. Both the Treasury and IRS have participated--the Treasury through legislative initiatives and the IRS with its regulations.

Some of the problems could have been mitigated had Congress had a mechanism for a thorough review of administrative impact or if review by the congressional Budget Office were not perfunctory. Within the IRS, review of interpretive regulations for administrative burden has also been perfunctory in recent years.

As desirable as simplification sounds, a number of forces within our system work against it. For example, the fact that much legislation is revenue-driven can lead to complex provisions that have a onetime impact on revenue. Further, almost all recent tax legislation has been enacted in a crisis atmosphere. Mr. Egger expressed little optimism for improvement in the legislative process as long as budget pressures remain.

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*Roscoe L. Egger, Jr. is presently a consultant with Price Waterhouse, Washington National Tax Office. He was formerly Commissioner of Internal Revenue.

Don J. Summa is Professor of Accounting and Applied Research in Taxation at the School of Business Administration of Monmouth College in New Jersey. From 1948 to 1986, he was the Senior National Tax Partner with the firm of Arthur Young.

William F. Nelson is a partner in the firm of King & Spalding. From 1986 to 1988, he served as Chief Counsel for the Internal Revenue Service.

Jennie S. Stathis is the Director of Tax Policy and Administration Issue for the U.S. General Accounting Office.

There may be room for improvement in tax administration, however. He suggested an expanded role for the Assistant to the Commissioner for legislative liaison. Regulations, published rulings, and revenue procedures should be reviewed objectively for administrative impact. A taxpayer ombudsman could play a role in identifying problems before regulations and rulings are published. The objective would be to provide a mechanism for identifying problems and an effective liaison with Treasury Tax Policy.

The first panelist, Jennie S. Stathis,[2] agreed with Mr. Egger that lack of credible evidence of the effect of proposals contributes to complexity. She noted that the IRS already has a great deal of information about the effect of changes in the law on taxpayers, but that, unfortunately, it is not accumulated in one site. One example is the tax forms committee that puts together prototype forms. Their efforts often reveal unexpected complexities. In addition, IRS focus groups are sometimes used to evaluate forms. Compliance teams in IRS service centers study tax returns as they are filed to identify problems early, and from time to time the IRS polls taxpayers and conducts interviews.

Ms. Stathis suggested that the IRS should also provide information on how proposals affect its ability to administer the law. Ways should be found to solicit such information from the IRS's own professional staff. Of course, for all this information to be useful, the IRS needs time to react to new proposals, and it is important that people who will use and evaluate the information have some practical experience as well as professional training. It also would help if new legislation provided for delayed effective dates or for a period of time to evaluate effects.

Ms. Stathis concluded her remarks by agreeing with several earlier speakers that the structural deficit problems must be solved. Otherwise, revenue concerns will continue to take precedence over complexity concerns.

William F. Nelson,[3] the second panelist, stated that the IRS has learned from past mistakes and now recognizes that is has no interest in greater complexity. The Service, however, has had relatively little ability in recent years to affect legislation.

The Treasury speaks for the administration on tax policy matters and must support its positions even if complexity is increased. If the Treasury raises complexity issues, those complaints may be used against administration proposals. Policy concerns must come first, and Mr. Nelson noted, "simplicity is really at the other end of the seesaw from all the other policy considerations."

In spite of these factors, Mr. Nelson noted that the Service can help reduce complexity (for example, by testing forms and providing better guidance through its regulations). These should not necessarily be short--they must answer taxpayer questions. Nor should they answer questions that do not need to be answered. They can and should be written more clearly. Mr. Nelson observed, however, that such changes require substantial time and effort and would not have a major impact on simplification.

Following Mr. Nelson's remarks, Don J. Summa asked Mr. Egger to comment on whether the Service can be more effective in dealing with legislative changes at the

congressional level or by working through the Treasury Department. Mr. Egger reiterated his belief that complexity is often introduced as a result of legislation motivated primarily by revenue concerns. Examples are acceleration of the remittance of withheld taxes and the uniform capitalization rules. Mr. Egger believes the Service can be more effective in administering the tax law with its writing of instructions, development of forms, and wording of regulations.

Mr. Nelson commented than when complex regulations go forward, it usually is because someone--the Commissioner or Assistant Secretary--has decided they should go forward in spite of the complexity because other policy considerations are considered more important. An advocate of simplicity should be someone who understands these considerations.

Mr. Egger then returned to Mr. Summa's original question. He stated that the Service should work through the Treasury to the greatest extent possible; it would not be desirable to have both the Treasury and the Service attempting to deal with Congress on policy issues.

Mr. Summa then invited questions and comments from the floor. The first participant agreed with Mr. Egger that the Service and Treasury cannot act independently on the Hill in drafting legislation. However, the Service can play a role in the development of legislation as it did with the 1969 Act, by drafting legislation before it is considered for enactment. The speaker noted that TRA 1986 was actually voted on without being drafted and that the recent trend has been to release temporary regulations without opportunity for public comment. He called for a return to full participation in the development of legislative and regulatory language. Mr. Nelson followed up on this comment by noting that the Taxpayer Bill of Rights requires that proposed and temporary regulations be finalized within three years.

Another participant proposed several ideas to change the attitudes of policymakers toward complexity. One was to develop ways to define and measure costs associated with complexity. These would include such costs as lower taxpayer compliance and additional training for IRS employees. Another idea was to attempt to validate whether the current approach to regulation writing (that is, trying to answer every potential question) is necessary. A third idea was to bring individuals other than attorneys, accountants, and economists into the discussion. Suggestions include experts from psychology, management, public relations, and computer science.

The next participant noted that in recent years effective dates for tax legislation have been in the last quarter of the year, giving the Service very little time to design forms and write instructions. He recommended barring tax legislation after a certain date, to give the Service the needed time. Both Mr. Nelson and Mr. Egger supported this proposal.

The recent changes in civil penalties (development of a uniform base for accuracy penalties, elimination of interest components, and coordination of the delinquency penalty with other penalties) were pointed out by another participant as an example of simplification that was accomplished without revenue costs. The process began in 1987

and involved the General Accounting Office, the Commissioner's Advisory Group, the American Bar Association, and the AICPA. Other parts of the Code could also be identified and simplified through similar cooperative efforts.

The final comment came from a participant who suggested that the GAO put a higher priority on its studies that relate to complexity, that renewal of district conferences be considered as a way to resolve many issues at a less intense level, that complexity is compounded by differences between financial accounting and tax accounting (such as the uniform capitalization rules), and that it would be desirable to increase the program for short-term assignment of IRS personnel to Hill positions.

Mr. Summa then called for final comments. Mr. Egger stated that most of the comments were consistent with his own objective of identifying a mechanism by which the Service could help reduce complexity. Mr. Summa agreed and stated his hope that some of the suggestions could find their way into actual use.

ENDNOTES

[1] Mr. Egger's Conference Paper is reproduced in Part I (G-1).

[2] Ms. Stathis's comments are reproduced in Part I (H-1).

[3] Mr. Nelson's comments are reproduced in Part I (I-1).

Complexity in the Tax Legislative Process: Problems and Proposals, Role of the Congressional Staffs and Taxpayer Representatives

Session 4: Thursday Afternoon, January 11, 1990

Presenter:	Bernard M. Shapiro
Moderator:	Jay Starkman
Panelists:	Robert N. Mattson
	Ronald A. Pearlman*

The purpose of this session was to focus on complexity in the tax legislative process. The moderator, Jay Starkman, began the session by noting that the drafters of the Constitution never envisioned an income tax and that the original proponents of the income tax probably did not envision its present complexity.

The first speaker, Bernard M. Shapiro,[1] stated that the source of much of his paper was a diary he kept during his years on the Hill. He noted that when he was a member of the Joint Committee staff, a number of simplification projects were undertaken and that simplification had a high priority for the staff. In spite of this emphasis, Congress was not always receptive to simplification. Mr. Shapiro cited the example of a project begun in 1966 to remove "deadwood" from the Code. It was completed by 1969 but not enacted until 1976 when the perseverance of the Chief of Staff finally paid off.

The purpose of Mr. Shapiro's conference paper was to focus on tax simplification in the present environment of the legislative process. In this environment, he stated, there must be a vocal constituency for simplification, and the legislative process must change.

With regard to the first issue, he drew the conclusion that there is no public constituency for tax simplification. Of course, members of Congress and the public would respond affirmatively if asked if they support simplification. When they are confronted with choices between simplification and self-interest or constituent interest, however, simplification loses.

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*Bernard M. (Bob) Shapiro is the National Director of Tax Policy and Legislative Affairs for Price Waterhouse. From 1977 to 1981 he was Chief of Staff of the Joint Committee on Taxation.

Jay Starkman is a CPA with his own firm in Atlanta Georgia. He is Chairman of the Tax Simplification Subcommittee for the American Institute of CPAs.

Robert N. Mattson is Assistant Treasurer, IBM Corporation.

Ronald A. Pearlman is Chief of Staff of the Joint Committee on Taxation.

Mr. Shapiro then examined the tax policy causes of complexity. When the system is used for purposes other than revenue raising, complexity is introduced. When taxpayers begin to benefit too much from tax incentives, tax reform is introduced. This, of course, adds new complexity. Finally, compliance provisions are required to enforce the new provisions.

In the 1980s, presidential politics--in particular, campaign promises--have shaped tax policy. The resulting changes, coupled with the effect of indexing and the budget deficit, have led to tax bills, written under great time pressure, of which revenue was the driving force.

Since finding a public constituency for tax simplification is unlikely, Mr. Shapiro believes changes within the process must be made. First, the federal budget process must be dealt with so that tax bills are not entirely revenue-driven. Possibilities are a "deficit surcharge," suspending or cutting back indexing, and adoption of a two-year budget cycle.

More promising than changes in the budget process, perhaps, is the possibility of a constituency within Congress for simplification, with the Joint Committee as the focal point. The statute that created the Joint Committee in 1926 calls for it to investigate measures and methods for the simplification of federal taxes and to publish from time to time an examination and analysis of these measures and methods. This committee could work with the Ways and Means and Finance staffs and with the Treasury and IRS to initiate projects in which simplification is considered before revenue issues are raised. Simplification should be part of every proposal that comes from the Treasury Department and from the congressional staffs. The tax writing committees should each have a task force with the responsibility of raising the question of simplification when proposals come up. The hearing process should be more deliberative, with a panel dedicated to raising issues of tax simplification. Finally, more time is needed for drafting statutory language. Today, the pressures of the drafting schedule leave too much detail to regulations and technical correction bills without considering the added complexity.

The first panelist, Robert N. Mattson,[2] called for a disciplined approach and greater accountability on the part of drafters of statutory language. In particular, he was critical of statutory language designed to correct perceived abuses or restrictive rules. Such rules causes transactional and compliance complexity and are better left to administrative regulation or rulings.

Mr. Mattson noted that large corporations have experienced an increased burden in data collection costs and a significant increase in tax return preparation time. He offered the foreign-source income area as a particularly frustrating example.

Mr. Mattson agreed with Frederic Hickman that excessive language in the Code does not reduce ambiguity but may, in fact, increase uncertainty. He disagreed that a deficit surcharge, such as that suggested by Mr. Shapiro, will reduce complexity. Instead, such rate increases would kill the effort to achieve simplification. This would happen because rate increases result in competitive losses to U.S. businesses and lead to further complexity as the need for incentives and exceptions filters into the system. Further, to

require that simplification be directly tied into a revenue-raising bill would have the result of making simplification a "stalking horse" for a tax increase. Like Mr. Shapiro, Mr. Mattson called for leadership from the Joint Committee to suggest ways to simplify the Code.

The second panelist, Ronald A. Pearlman,[2] is the current Chief of Staff of the Joint Committee. He began by asserting that members of Congress and their staffs also find the volume of recent tax legislation overwhelming. Unfortunately, it is unrealistic to expect this activity to subside, partly because of the need for revenue and partly because of increased numbers of proposals from many sources for new programs and tax incentives. He further noted that increasing tax rates will not resolve the problem. The effort to accurately measure taxable income is and should be an ongoing process.

In spite of these facts, Mr. Pearlman stated that complexity in the tax law is a concern for people involved in the tax legislative process. It is not, however, at the top of their agenda, sometimes because of politics and sometimes because of lack of time.

He noted that there have been some successful efforts to reduce complexity. Recent examples are the provision to allow parents to include children's income on the parents' return and the 1989 alternative minimum tax change.

For the immediate future, the staffs may not have time to enumerate and draft simplification projects, but it is possible for them to identify discrete projects for further consideration. Mr. Pearlman suggested the personal interest expense deduction and the foreign provisions as promising areas for simplification.

Mr. Pearlman concluded by noting that the real difficulty is how to identify and respond to complexity that develops as new tax proposals evolve. Part of the problem is lack of time; part of it is lack of outside input, even when proposals have been public for some time. He stated that members of the staffs are genuinely interested in addressing the problem and happy to work with others in the government as well as professional organizations to make progress.

The moderator, Jay Starkman, responded that the AICPA Tax Simplification Subcommittee had experienced no difficulty in reaching members of the Joint Committee staff. He then opened the floor for questions and comments.

The first participant asked if there is room in the legislative process for substantive tax rules that would have the effect of removing incentives for complex taxpayer behavior. As an example, he suggested treating all gifts and bequests as income and repealing the estate and gift tax. A second example would be adoption of a single uniform rate for all taxpayers, corporate and individual, thereby reducing incentives to shift income. Mr. Pearlman noted that it is very difficult to make a single rate system progressive, even with personal exemptions or standard deductions. With regard to the first example, he observed that repealing section 102 (exclusion of gifts and inheritances from gross income) would be less popular than repealing the estate tax.

The next comment came from a participant who offered two examples of taxes that may be characterized as "simple" but cause complexity for taxpayers. The first was the employment tax, which can be very complicated if the issue is who falls within the withholding system. The second example was any provision that is simple for most taxpayers and complex only for large (corporate) taxpayers. These provisions make voluntary compliance difficult and subject taxpayers to the substantial underpayment penalty.

The next question was addressed to Mr. Pearlman. The participant asked what is the future of the Subchapter C Revision Bill of 1985 given the repeal of the General Utilities doctrine and what is the role of explicit statutory elections in subchapter C. Mr. Pearlman stated that the best way to deal with complexity that arises out of subchapter C provisions is on an incremental basis and not in a massive revision.

Another participant challenged the group to oppose any efforts to reduce the capital gains rates. He noted that such a change would benefit many of the participants and their clients but would greatly increase complexity.

The next participant opposed the notion that the appropriate way to meet budgetary needs is to make adjustments to the tax base. Recent adjustments have been tied to the amount of revenue they produce, not to making the base more logical or simple. Raising revenues should be accomplished instead by raising rates.

The tendency to blame complexity on taxpayers who do not want simplification unless it is to their benefit was criticized by another participant. He asserted that the focus of the conference should be on the cost to companies of complying with complex provisions such as the uniform capitalization rules. Such provisions cause advertent and inadvertent noncompliance. Mr. Shapiro responded that attention to the benefits and detriments of tax provisions is appropriate because that is how individuals look at tax simplification. He agreed that a broader perspective is also appropriate.

The difference between complexity and uncertainly was discussed by another participant. He noted that some "simple" provisions such as section 269 (acquisitions made to evade or avoid income taxes) are difficult to comply with whereas a very complex provision such as section 382 (loss carryforwards) may actually be relatively easy to comply with because of greater certainty. Mr. Mattson responded that uncertainty is a major problem for large corporations because of the number of issues for which there is little or no specific guidance.

The final comment came from a participant who suggested that each person attending the conference "undertake the education" of members of Congress in their districts who are members of the tax writing committees. In particular, he suggested enlisting others (such as fellow ABA members) who would form a constituency to communicate with legislators and their tax legislative assistants. Mr. Shapiro noted that specific proposals are needed, not just general support for simplification.

Mr. Starkman then called for final comments. Mr. Shapiro stated that in his paper he is not calling for a deficit surcharge but rather he is criticizing the current process by which budget bills raise revenues. If there were a deficit surcharge in the budget process, he believes members would support budget cuts in lieu of rate increases.

ENDNOTES

[1] Mr. Shapiro's Conference Paper is reproduced in Part I (J-1).

[2] Mr. Mattson's Conference Paper is reproduced in Part I (K-1).

[3] Mr. Pearlman's comments are reproduced in Part I (L-1).

Eliminating Complexity for Individual Taxpayers:
A Revenue Loser Without a Constituency?

Session 5: Thursday Afternoon, January 11, 1990

Presenter:	Deborah H. Schenk
Moderator:	Donald C. Wiese
Panelists:	Betty R. Jackson
	Steven D. Kittrell*

The moderator, Donald C. Wiese, noted that whereas the four previous panels focused on the process by which complexity is introduced into the tax law, the purpose of this and the subsequent panels was to focus on complexity in specific areas of the law. This particular panel was concerned with the effect of complexity on individual taxpayers and the family unit.

Professor Schenk[1] began by quoting several conference speakers who had asserted that tax complexity is not really a problem for most individual taxpayers. She noted that this assertion is inconsistent with the fact that even though 71 percent of taxpayers do not itemize deductions, 50 percent use a paid preparer and many others have unpaid assistance.

She acknowledged that TRA '86 did remove a number of taxpayers from the rolls and that there is a general belief that tax return preparation is simpler for many other individuals. Several examples, however, illustrated the complexity that can be associated with commonly faced issues such as determination of filing status or deductibility of interest.

Professor Schenk agreed that individuals are more interested in reduction of tax liabilities than simplification. In spite of this, there should be a constituency for simplification because of the effect of complexity on compliance by so-called level 2 taxpayers. Further, low-income taxpayers (level 1) are losing benefits targeted at them because they cannot understand the provisions.

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*Deborah H. Schenk is Professor of Law at New York University School of Law.

Donald C. Wiese is a Senior Partner in the National Tax Group of Deloitte & Touche. He is a member of the AICPA Federal Taxation Executive Committee.

Betty R. Jackson is an Associate Professor of Accounting at the University of Colorado.

Steven D. Kittrell is with the law firm of Golden, Freda & Schraub, PC, in Washington, D.C.

Professor Schenk then turned to some specific suggestions that would reduce complexity for level 1 and level 2 taxpayers. Her primary thesis was that these taxpayers should be expected to comprehend the fewest possible concepts. Therefore, to the extent possible, definitions and qualifying thresholds should be uniform. As an example, a single qualifying threshold for claiming a dependent could be printed on the face of a tax return. Only those taxpayers who do not meet that threshold would need to read or understand more rules.

Three possible approaches to developing unifying principles for thresholds were proposed. The first approach would be to make sure each new piece of legislation that relates to low- or average-income taxpayers uses uniform thresholds. The second approach would be to eliminate small but complex requirements in the hope that over time the remaining qualifying rules and thresholds would be simpler. The third, and more radical approach, would be to provide "bright line" tests, with the understanding that some equity might be lost.

As an example of the third approach, Professor Schenk proposed that head-of-household status could be based solely on whether the taxpayer has a dependent. A further simplification would be to allow a person who is separated but unable to divorce for economic reasons to claim the "abandoned spouse" status.

Such an approach would greatly simplify the law and process for level 1 taxpayers. It also would improve equity because taxpayers who are entitled to benefits would not be denied them because they could not understand the rules. It could be made revenue-neutral by reducing the associated tax benefit or by limiting the use of benefits by higher-income taxpayers. Another way to view it is that the "revenue" lost should never have been considered revenue at all.

Another "radical" proposal would be to provide a single support allowance that would not be subject to federal income tax. The allowance should vary with level of income, family size, and marital status and would replace the current system of standard deductions, exemptions, and the earned income credit.

Professor Schenk then discussed approaches to reducing complexity for level 2 taxpayers. These people face complex recordkeeping requirements and regulations that are often ignored. An example would be an individual who owns a single rental unit. One way to reduce complexity for this taxpayer would be to require that rental expenses equal a fixed percent of rental income. Record keeping would be greatly reduced and the passive loss rules could be ignored. Obviously some taxpayers would benefit and some would not, but the rules could allow the losers to keep records if they wished to prove their losses.

Professor Schenk also discussed some domestic relations issues. For example, she proposed allowing taxpayers to designate payments as child support or alimony without complicated tests. With regard to the "kiddie tax," she proposed requiring that children's unearned income be reported on parents' returns.

In conclusion, she made an appeal for better coordination of state and federal tax laws. While not offering any solutions, she noted that for many taxpayers, simplification of federal tax law would provide only limited relief if not accompanied by state simplification.

The first panelist, Betty R. Jackson,[2] began with reference to the equity-versus-simplicity seesaw analogy. She stated that "we have been feeding the equity side too many high calorie meals," and that it is now "time to starve equity a bit so that simplicity can have enough weight to balance the seesaw."

Referring to Professor Schenk's paper, she supported the proposal to eliminate the AMT for individuals. The number of taxpayers affected decreased from 609,000 in 1986 to 114,000 in 1987. Although some revenue would be lost, it would be more rational to attack remaining preferences directly rather than to maintain a dual tax system.

Professor Jackson also noted the difference between what is fair and what is perceived to be fair. In our system, we sometimes go to elaborate lengths to achieve equity only to create a system taxpayers perceive as unfair. She offered the 33 percent "bubble rate" as an example. Even her students, who understand how the rate structure is constructed, perceive it to be unfair. She believes this perception can be explained by research in psychology that demonstrates that people perceive outcomes according to the way a situation is framed. The tax benefit given on lower-income levels is viewed as an endowment bestowed on every taxpayer. The "bubble rate" of 33 percent is viewed as unfair because loss of the benefit is more painful than the pleasure of the gain from the endowment.

Professor Jackson warned that if we choose to give up simplicity for the sake of equity, we must try to structure the law so that taxpayers perceive an increase in equity. She also noted that revenue estimates associated with changing the law often ignore behavioral responses to these changes.

The second panelist, Steven D. Kittrell,[3] began by agreeing with Professor Schenk that there is at best a very limited constituency for individual taxpayer reform. He noted that only the AICPA and ABA have been moderately effective voices for individual tax simplification.

He offered the example of the ABA/AICPA domestic relations tax reform project. After several years of work, a proposal was put forth. It took two more years to get the attention of Congress. At every step of the process, starting with Ways and Means hearings, complex provisions were added to the proposal. In each case, the intent was to try to prevent some perceived abuse or inequity. For example, the alimony recapture rules were designed to prevent front-loaded alimony payments with little attention to whether this was a bad thing to happen. The result of this process was a minor reform instead of a substantial reform.

Mr. Kittrell stated his belief that a conceptual framework is as important for addressing individual tax issues as it is for reforming Subchapter C. He proposed as a framework the concept that, whenever possible, the law should follow the expectations of

individual taxpayers as to what the right result should be. He asserted that taxpayers are more likely to follow the system if it conforms to their expectations. For example, most taxpayers would assume that alimony payments are deductible by the payer and taxable to the recipient. Likewise, aggregation of a child's income with the parents' income conforms to our understanding of the parent-child relationship. Mr. Kittrell noted that Professor Schenk's proposal in her paper to treat a simplified support test as the first screen for determining the dependency exemption also conforms to taxpayer expectations.

Mr. Kittrell concluded with a discussion of the "morass of current child support rules" as the direct effect of efforts to eliminate any perceived bad effects. A better alternative, one that would conform to what people expect, would be to use the amount designated by a judge as child support.

Mr. Wiese then called for questions and comments. The first came from an individual who noted that in studies of complexity, credits such as the child care credit and the earned income credit score very high in complexity ratings. These same credits are associated with significant compliance problems, even when returns are prepared by paid preparers.

Another participant noted that Congress, their staffs, and practitioners all have limited time to devote to the reduction of complexity and that priorities must be set. Professor Schenk agreed and stated that the issues she raised should be at the top of the list.

The next participant emphasized the effect of complexity on taxpayer compliance. He stated that if we are not getting revenues, we are realizing equity gains only on paper.

Professor Schenk's proposal to use a tabular approach to the standard deduction reminded another participant of the fact that TRA '86 Act replaced the zero bracket amount because Congress thought taxpayers would get a good feeling from explicitly taking the standard deduction. He then asked the panel if any of them agreed that TRA '86 also had reduced problems for many taxpayers. Professor Schenk responded that those taxpayers who no longer have to file returns are better off. TRA '86 also removed the double deduction of the personal exemption for dependent children but unfortunately did not simplify the definition of an exemption.

Another participant attributed much of the complexity discussed to patching provisions as problems arise. He proposed having a task force come up with proposals to simplify the tax system for individuals. Such proposals should be presented to the tax writing committees in much the same way as the recent penalty provisions were presented.

The next participant noted the lack of emphasis on the effect of complexity on tax administration. He stated that in his experience a number of level 1 and level 2 taxpayers do not understand the tax administration system and do not have the resources to hire professionals to protect their interests. Professor Schenk agreed that a great deal of anger taxpayers feel toward the system is caused by their contact with those who administer the system.

One of the conference organizers stated that the organizers share Professor Schenk's orientation. He noted that only four substantive areas were included in the program and that many subjects "closer to the pocketbooks" of participants, such as uniform capitalization rules, were not included.

The final comment of the day came from a participant who stated that the ABA Tax Section had made Professor Schenk's dependency exemptions proposals its highest priority among recommendations to the tax writing committee.

ENDNOTES

[1] Professor Schenk's Conference Paper is reproduced in Part I (M-1).

[2] Professor Jackson's Conference Paper is reproduced in Part I (N-1).

[3] Mr. Kittrell's comments are reproduced in Part I (O-1).

WELCOMING COMMENTS--JANUARY 12, 1990

Jere D. McGaffey*

On behalf of the ABA Tax Section, I want to welcome you all to this conference. We have for a long time been devoted to simplification. You can see the results of our past efforts in the Internal Revenue Code, though we do take some pride in some of the items where the simplification effort has been successful, such as in the installment sale provisions and S corporations.

Yesterday, we devoted a great deal of time to the process. With the last paper yesterday and in the papers today, we are devoting our time to various individual items. I believe and hope that the problem of tax complexity is not as simple a construct as the seesaw example that we were given, with simplicity on one side and tax policy and revenue on the other. I'm hopeful, at least, that it is a more complex vehicle and that we can identify areas in which these two items are not mutually exclusive.

We would hope that the papers that we're discussing today and the last one of yesterday will stimulate all of us to work, through our organizations, to identify various areas in which there can be a solution that is simpler, without changing the balance which policy and revenue has reached.

This work may not be as exciting as changing the tax policy or finding revenue raisers or reducing taxes, but it is certainly a very important contribution to the tax law for our clients and for ourselves. I think we must continue to devote ourselves to being that constituency that favors tax simplification, and we must be heard more often on that subject.

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A PRACTITIONER'S CONCERNS ABOUT UNDUE COMPLEXITY

JANUARY 12, 1990

HERBERT J. LERNER*

While the title of this presentation is "A Practitioner's Concerns," it's obvious we're all practitioners and all have similar concerns about this issue or we wouldn't be taking our time to address it at this conference. This is just one practitioner's view, with a little more slant toward the CPA's concerns.

As many of the speakers at this conference have indicated, there's not much serious debate about whether the present system is complex. It is so. I think we can fairly acknowledge that, and it probably has to be so in our present business environment. We can debate in general terms its degree, but I think most practitioners who have reason to deal with the compliance and planning aspects of our present system would say that it is unduly complex for them as tax professionals. I say that with a lot of feeling about trying to serve clients in both the area of compliance and planning advisory services.

Most CPAs or lawyers who serve individual or corporate clients, who have business activities or engage in transactions that cause them to be subject to the high degree of complexity of our present system, really face that in spades because of the nature of their client base. This is the so-called category 3 client, the one who needs expert service, the one whose transactions are impacted by special rules, and the one who suffers most from burdensome recordkeeping requirements. They often have activities that subject them to complex rules such as those associated with the AMT.

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Mr. Lerner received his B.S. from Rutgers (1959) and his LL.B. from Georgetown University (1963). He has served as an adjunct professor at Georgetown University Law Center and has lectured before numerous tax institutes. He is the author of numerous articles, which have appeared in such publications as Taxation of Accountants, TAXES, the Tax Adviser, the Banking Law Journal, the Journal of Taxation, and the National Law Journal.

That isn't true for the universe of taxpayers, but it clearly is true for the clients who are served by most lawyers and CPAs as outside advisers. It's true for our corporate clients and most of the clients of tax professionals who are full-time tax professionals serving corporations with multinational interests. The foreign rules are excessively complex. The current consolidated return rules are complex, although I think the post-1965 version of those rules is a significant improvement over the older rules.

But we continue to see a layering of changes, since there are other changes in the tax law that get layered into an otherwise detailed set of rules reflected in the consolidated return area.

Depreciation--with its multiple calculations for state tax, federal tax, AMT purposes, and so on--is obviously faced by this corps of clients whom most of the active tax professionals tend to serve, as is true for earnings and profits calculations if you serve multinational clients having to deal with complex rules for regular purposes and different rules for section 902(d) purposes, and perhaps different elections for section 964 purposes, and on and on.

Many of our clients also face special industry rules, special incentives (such as the R&D credit), and the other general rules, some of which are going to be discussed later today, dealing with passive losses or the complex pension provisions. I think it's fair to say that historically, there has been a lack of empathy on the part of tax-writing committees and their staff, as well as perhaps staff in the Treasury, to this problem of complexity for those who should be in the know, the assumption being that the tax practitioner community can effectively deal with any level of complexity because they are being paid fees by wealthy individuals or large taxpaying businesses and, therefore, can suffer the burdens of complexity in it. I would certainly agree it's easier to do so than for the more modest taxpayer population.

But I'm convinced that these groups, lawyers and CPAs advising their clients, have reached their capacity to cope with the present system. I don't think we're at just an upward trend in the level of complexity. I think we have a crisis situation. I say that both for lawyers and CPAs, but I think the CPA may have a special burden, largely because while both lawyers and CPAs are involved in the planning aspects of tax practice, CPAs are much more directly involved in the compliance side of practice. And so it isn't long after a 1989 enactment that CPAs have to deal with first-quarter financials that are impacted by changes in the 1989 act. The same thing was true in 1988 and 1987: first-quarter financials impacted by a major series of changes without the benefit of even reasonably prompt guidance because that guidance can't be expected to occur within the first three months following the change in the law.

The same is true for purposes of filing returns. CPAs assisting in the preparation of returns need to address problems such as estimated tax payments for those who choose, and are able, to file a timely return. There's a very short time frame between detailed legislation and a required significant effort on the part of CPAs to both understand and then apply very recent tax law changes.

Everyone expressed yesterday the concerns about lack of certainty in our present system. But I want to share with you that deep-seated concern that I think CPAs have about the pace of legislative change. That concern is reflected in a number of developments. First, I think there are a discernible number of tax practitioners who have just given up on the tax profession. They thought it was a nice profession to be involved with, but rather than face ten tax acts in the last ten years and try to assimilate that, they've just given up on the profession. That's unfortunate, not because we may not need room for other tax practitioners, not because those who aren't mentally nimble can't effectively serve clients. I think it's the frustration of dealing with the degree of change that we've been involved with.

I think, also, that there is a lack of the same degree of satisfaction in tax practice, both from a lawyer's and a CPA's standpoint, by virtue of the absence of meaningful tax policy reflected in legislative change. It's okay to deal with specific rules, a rule-directing system, but that isn't what provides the kind of mental stimulation that most people who are involved in tax practice find satisfying. So there is today a much less satisfying atmosphere for tax practitioners which reflects the fact that we do not have a coherent tax policy in the Code that we, as professionals, are dealing with.

Some examples of that would be hard to justify in dialogue with a client, such as the effect of three successive one-year extensions of credits like R&D, targeted jobs tax credit, and so on. Three successive one-year extensions are less costly to the budget than one three-year extension! We extend things to September 30, 1990, rather than for three years, because even if we come back to deal with it in 1990 and extend it another year, the overall impact on the budget will be diminished. It will be diminished because we take into account the certainty of taxpayer activity which, given a three-year extension, would permit people to plan for and effectively utilize an intended benefit.

Short-term extensions cause less application of the benefit and, as a consequence, have less impact on the budget. That's a sad circumstance. It's difficult to justify to clients, and difficult to justify to ourselves, frankly, as part of the overall tax system.

Reflective of the impact of complexity on practitioners is a noticeable increase in the number of both favorable and unfavorable responses to Form 9100 requests. As you know, this permits a taxpayer to secure an additional extension of time from a reg-prescribed time filing to take some action (typically, an election provision) that was missed because of reliance in good faith on advice of a third party, a CPA, or a lawyer. Typically, it is predicated on that circumstance, and when identified, one can go into the Service and seek a further extension of time for performance.

That IRS request requires an acknowledgment on the part of that professional adviser, the CPA, or lawyer that his or her advice was faulty, and the faulty advice of the professional adviser is the basis for the IRS's favorable response. Now there isn't a clear indication of how many Form 9100 requests are submitted and not responded to favorably by virtue of their being withdrawn after dialogue with the Service. But we do know, for example, that there's been a substantial and growing number of these cases over the past number of years, ranging from a low in 1984 under my calculation of just over 150

responses (including a denial rate of only 15 percent) to approximately 500 responses in 1989. And the Form 9100 requests in the area of missed-accounting-period and accounting-method issues, which really impacts CPAs in practice more than other professionals, are a large portion of the 1989 figure.

I think professionals, who are no less interested in advising clients correctly today than they were before, are just unable to cope with the degree of change and, therefore, their quality of service has been diminished. That ought to be troublesome to all of us. It's troublesome to the in-house lawyers at our firm. I'm sure it's troublesome to our clients who receive faulty advice, and we're not unique in that respect. It's a difficult, disturbing development.

I think also the fact that we have a need for a degree of increased specialization (whether that's functional specialization such as in the ERISA area, or industry specialization such as in the banking or health care or other areas) causes some individuals who are so highly specialized not to be able to see the forest for the trees. And as a consequence, their ability to deal with more general issues is diminished.

In a large firm one can have specialists and generalists attacking a client problem, if the client is large enough and the problem is meritorious enough and significant enough to justify all that involvement. I feel much more sympathy for the smaller practitioner who doesn't have that kind of capability and still must face those problems. It's an exceedingly difficult and unfortunate problem, and it's a reflection of the present system that we have.

The use of the Tax Code to regulate other nonfiscal behavior has also fueled the fan of complexity. And while all of us have dealt with things like the "golden parachute" rules, gas guzzlers for autos, just think about the 1989 act provision dealing with ozone-depleting chemicals. I and a whole lot of other interested people think that we ought to do something globally to decrease the penetration of the ozone layer. It's obviously a serious problem. We now have a provision enacted in the 1989 act that would apply to all those ozone-depleting chemicals that were listed in the Montreal protocol in which all the industrialized nations agreed to try to reduce their production and consumption of ozone-depleting chemicals. So we have an excise tax that's accomplished by varying rates applicable to different specified chemicals and differing periods. It isn't limited to that. It has exceptions and exemptions for recycled ozone-depleting chemicals and for those used in making rigid foam insulation; halons are dealt differently than other chemicals, and so on.

The tax isn't just imposed on manufacturers who in their manufacturing process use ozone-depleting chemicals; it's applied to those who import products produced abroad that included those same kinds of chemicals, so that refrigerators, computers, VCRs, and a whole host of items of that type--electronic typewriters, stereo tapes, washers and dryers, computers, tape recorders, sterile packaging, and so on--are listed as possible products that have ozone-depleting chemicals and may give rise to floor stock taxes for all U.S. retailers of all of those products that are imported and on their premises as of January 1, 1990. A very, very complex problem, one that I'm sure most of the retailers in the United States

have no understanding of other than their interest in the general notion about saving the atmosphere. It's because we're predisposed to using the tax system in that manner and with that kind of complexity that I think we face problems like that.

I think it's fair to say that, from this practitioner's standpoint, the current law can't be effectively or efficiently administered by the IRS in its field operations, largely due to the level of complexity. We face the same problems of training a multitude of people in a large firm. The IRS faces an incredible problem of trying to train its people in the legislative developments as well as the reg developments. A recent survey by the AICPA identified this as a clear view of the majority of responding CPAs. The last commissioner, Commissioner Gibbs, and other commissioners indicated in communications to the chief counsel's office their concern about the current level of quality of attorneys in the IRS chief counsel's office. That's not to suggest that we don't have quality, but the quality may not be keeping pace with the degree of increased complexity. It's a very serious problem, now recognized by both professions.

Well, what should we do about it? A lot of things are going to come out of this conference that are going to address the problem. The most important item, I think, is--without regard to your view on the desirability of the present system--that we would all benefit from a marked moratorium on legislative change, except if it served an overriding economic need or if it served to diminish the level of complexity in the present system. That's easy to say and obviously very hard to implement, but we need to feel that is an important objective, because if we don't even talk about it in those terms, there won't be a shared sentiment that many of us have expressed at this conference.

I think we've got to reinstate those approaches that were preferable in prior years in terms of dealing with legislative change. We've had a lot of discussion here about the favorable results in the installment sales area. Well, it was both a privilege and pleasure to deal with that subject in 1980; I think it was also a personal pleasure to deal with a point person from the ABA, Marty Ginsburg, who did the job on that subject, and people in the Treasury like Hank Guttman and Don Ricketts, who did work when he was on the Joint Committee staff. A fine collegial effort in that area--it was true of divorce and alimony, and it was true of subchapter S, in which where the Bar, AICPA, Treasury, and Hill staff collaborated to end up with useful, complexity-decreasing legislation. Penalty reform in 1989 is another good example.

An example of a lousy one, frankly, is the effort of the AICPA in 1987 to seek to remedy a major problem from the CPA practitioner's standpoint (that is, dealing with fiscal year legislation and otherwise-required change for S corporations and partnerships to the calendar year). We did not have a collegial effort on that problem. We did not have participation by the Bar Association on that problem. We did not have active support from the Treasury Department on that problem. Late support, but not in the ongoing process. We did, through effective grass roots effort, solve a very critical problem for the CPA profession. Concentration of work in such a short period of time would have accentuated the problems of quality of service if all the smaller entities in the United States that were on fiscal years had been required to go on a calendar year. And we solved it with a not-uncomplex section 444 and deposit arrangement. It's sad because we had a problem that could have been resolved in a different matter had we had the benefit of collegial effort.

What we need to do is reinstitute and rededicate ourselves to that kind of effort, from the CPA standpoint, the Bar standpoint, and the Treasury standpoint. It's in everyone's interest. It isn't just a matter for CPA concern.

I'd like to just touch base for a moment on some areas that I think collegial efforts would be particularly useful for. We need to establish one or more uniform rules for attribution that would have application across the Code. We really don't need multiple rules. We may need wide nets and narrow nets, but we don't need five different degrees of narrow nets in the Code.

In the area of pension matters to be discussed later by my partner, Dave Kautter, it's clear that there is a need for a collegial effort to address that area. We need a new "deadwood" bill. I was interested in Bobby Shapiro's remarks yesterday about the ten-year period in order to get a deadwood bill passed from the time of introduction in 1966 to 1976. Well, there's been a lot of deadwood reflected in the Code since 1976. A renewed effort in that area would be highly desirable.

We need to address and simplify the personal interest deduction. Even done clearly on a revenue-neutral basis, it still could be improved. In the foreign provisions, I think that we've got a hopeless problem unless we seek to simplify that area. And an area that is very ripe and not terribly difficult to deal with is the classification of employee versus independent contractor. Jim Merritt made mention of that yesterday. It seems to me that it wouldn't be too difficult to establish a legislative presumption that all payments to individuals are payments to employees and subject to employment tax, unless the payor receives an exemption certificate that causes it to be characterized as a payment to an independent contractor. Put the onus there. Don't leave the classification as an open issue, and don't face monthly the majority of such issues being reflected in private letter rulings and tech advices.

That's what we really need to home in on: those areas in which we have major controversy. We can see the proliferation of problems. It's reflected in the reporting that we either see in our practice or see reflected in publications of private letter rulings and tech advice. Those are areas we can deal with as professionals, and we can solve those problems. But we have to make a serious effort to do so.

I'm personally very encouraged by the kind of enthusiasm that I think is reflected at this conference. I would hope that enthusiasm is reflected in action by each of the constituent organizations (that is, government organizations, the AICPA, and the ABA). I would hope, for example, that the GAO would undertake that ultimate task that Jennie Stathis was so concerned about, and I think I understand her concern about trying to develop an equation between complexity and administrability. Get a relationship and be able to test and evaluate legislation and reg changes based on some standardized methodology to deal with that relationship, perhaps keyed into the revenue to be derived by the given provision.

I would hope that the Treasury would undertake independent studies on the level of complexity at some point after legislation is enacted. I would also hope that the Office

of Tax Policy within the Treasury would be substantially enlarged. I appreciate normal budgetary problems, but this is a major crisis for us. For example, the idea of having one accounting adviser in the Treasury Department's Office of Tax Analysis is, when you step back from it, an absurd circumstance. Having only twenty attorneys to deal with all of the Office of Tax Policy's concerns is shortchanging the public, shortchanging professionals, and shortchanging those twenty people who are working their tails off to try to solve those problems. A major focus of the Commissioner's Advisory Group ought to be to address and identify the kinds of problems that we're talking about here.

At-Risk and Passive Activity Limitations:
Should Complexity Be Reduced?

Session 6: Friday Morning, January 12, 1990

Presenter:	Stanley A. Koppelman
Moderator:	Ray M. Sommerfeld
Panelists:	Sally M. Jones
	Stefan F. Tucker*

This session was devoted to the question of whether complexity should be reduced in the at-risk and passive-activity-limitation rules. The moderator, Ray M. Sommerfeld, began with a quote from Elihu Root:

> I guess you will have to go to jail. If that's the result of not understanding the income tax law, I shall meet you there. We will have a merry, merry time, for all of our friends will be there. It will be an intellectual center. For no one understands the income tax law except those who have not sufficient intelligence to understand the questions that arise under it.

Stanley Koppelman[1] began his presentation by discussing the passive activity loss provisions and some possibilities for their simplification. He noted that these provisions disallow real economic losses as well as artificial losses and thus are unfair to taxpayers with real losses. The passive activity provisions are inherently complex because they are based on the "basket approach," under which current passive activity losses can be used only to offset passive activity income. This approach invites transactional complexity. Moreover, congressional efforts to limit transactional complexity have added further complexity.

In spite of these defects, Professor Koppelman did not advocate the repeal of section 469. He stated that the result of repealing section 469 is unknown. One view is that repeal

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would cause a return to the pre-1986 days of tax shelters. Another view is that various other provisions (such as reductions in the cost recovery rates, the elimination of the investment tax credit, and the demise of the capital gain preference) would prevent a re-emergence of tax shelters. Professor Koppelman stated that he had no firm conviction as to which view is correct but observed that the possibility of reinstating a capital gains rate preference militates against repeal.

He next addressed the question of alternatives to the passive activity loss rules that might provide greater equity and simplicity. One alternative would be to repeal section 469 and broaden the tax base. This alternative, although politically desirable, is unlikely. A second alternative would be the adoption of the limitation on artificial losses (LAL) approach proposed in the 1970s. Under this approach, artificial tax losses from an activity are temporarily suspended until they can be offset against income from that or related activities. This approach is preferable to the passive activity loss rules because it does not require suspension of real economic losses. Although it is thus potentially a more equitable approach, it does not necessarily promote simplification. It does, however, eliminate the need to define material participation and in that sense is simpler than the current rules. On the other hand, it requires the definition of artificial losses, adding a new complication.

Since limitation of artificial losses is not a simple idea to implement, Professor Koppelman then explored the possibility of simplifying the existing passive activity loss rules. He suggested that limited simplification is possible. For example, a gross income threshold could make the rules inapplicable to certain lower-income taxpayers. Further, some provisions (such as the exception for working interests in oil and gas properties) could be eliminated. Although the regulations that define an activity have been criticized as unduly complicated and unfair, Professor Koppelman was not optimistic that they could be meaningfully simplified. He noted that proposals to make these regulations shorter do not necessarily make them simpler; rather, shorter regulations may simply leave more unanswered questions.

He then turned to the at-risk rules. These rules were designed to limit abusive tax shelters and to correctly measure income in a system with a realization criterion. The issue is whether the at-risk rules can be eliminated in the interest of simplification. To do so would reduce complexity for those owning investments producing tax losses attributable to nonrecourse financing, but their elimination could increase transactional complexity for other taxpayers. The at-risk rules also simplify enforcement of rules preventing overvaluation of property. With no clear gain in simplicity from repealing the at-risk rules, Professor Koppelman favored their retention, arguing that they are consistent with the principle that a taxpayer should not be entitled to a deduction for a cost that he or she is not obligated to bear.

The first panelist, Professor Sally M. Jones,[2] focused on the at-risk rules. Unlike Professor Koppelman, she recommended repeal of section 465. She noted that before the at-risk rules were adopted in 1976, the tax writing committees had considered the limitation of artificial losses but rejected the notion because of its complexity. Two years later, Congress extended the at-risk rules to include not just specific types of shelters but any business activity except real estate.

Professor Jones observed that the passive activity loss limitation rules are much broader in impact than the limitation-of-artificial-loss rules Congress considered and then rejected in 1976. It would have been logical in 1986 to repeal section 465, which had proved to be ineffective at curbing shelters. Under current rules, a partnership with a loss is confronted with a series of Code sections that must be applied sequentially, beginning with the section 704(b) allocation rules, then the section 752 rules allocating nonrecourse debt to partners, then the section 465 at-risk rules, and finally the section 469 passive activity loss rules. To illustrate her point, Professor Jones referred to an example from Professor Koppelman's paper in which an individual has invested $200,000 of his personal funds in an activity financed with $800,000 of nonrecourse debt. The section 465 and 469 rules affect only the timing of the taxpayer's deduction of the $200,000 investment. Professor Jones asserted that the at-risk rules have "lasted well beyond their time" and should be repealed.

In conclusion, Professor Jones argued that there is no theoretical basis for allowing losses from one passive activity to affect income from another passive activity. In other words, section 469 should be activity-specific. She suggested this would simplify the statute, remove incentives to create PIGs, and relieve Treasury of the responsibility of writing regulations to interpret the existing rules.

The second panelist, Stefan F. Tucker,[3] began by noting that his perspective is that of a practitioner who represents clients in the real estate industry. To illustrate the complexity he and his clients face, he produced two volumes (1,517 pages) and three notebooks of section 469 regulations. He stated that additional "technical corrections" of these regulations are anticipated.

Mr. Tucker disagreed with an earlier speaker who predicted that tax practitioners will leave practice because of the complexity of the tax law. Instead, he stated his concern that younger practitioners will become autistic idiot savants, knowing everything about section 469 (or some other section) and very little about the remaining law.

Unlike Professor Jones, Mr. Tucker did not support the repeal of section 465 but called for a few changes making it applicable only to abusive tax shelters. He asserted that practitioners cannot live with section 469, particularly its regulations. He stated that in some cases it is impossible to provide clients with answers to basic questions such as whether income is active or investment income. He further noted that the regulations often produce surprising results. For example, holding land for the future construction of an office building can be treated as a trade or business rather than as a passive activity or investment.

Mr. Tucker noted that the type of client typically affected by section 469 is not a widely held C corporation but an entrepreneur who prefers playing the audit lottery to paying a tax adviser who cannot determine from the regulations what the "correct" treatment of an activity is. That fact alone, he asserted, is sufficient to call either for the repeal of section 469 or for the simplification of the regulations. With the elimination of the investment tax credit, longer depreciation lives for real estate, the regulation of S&Ls, the alternative minimum tax, and uniform capitalization rules, section 469 is not necessary.

Professor Sommerfeld then called for questions and comments from the floor. The first came from a participant who wondered if applying section 469 on an activity-by-activity basis might increase rather than decrease complexity. He noted that the purpose of section 469 was to prevent the offset of passive losses against labor income. As an alternative, he proposed combining section 163(d) and section 469. Both sections are concerned with income from capital, and combining them would eliminate the need to distinguish among different types of interest. Professor Jones agreed that the proposal of combining portfolio income with passive income would be theoretically sound and would simplify the tax law. Professor Koppelman questioned whether creating a broader basket would increase transactional complexity. Mr. Tucker endorsed the proposal. Professor Sommerfeld pointed out that this proposal might raise some new issues concerning the classification of income from property and services for purposes of allocating that income to the "labor" or the "capital" basket.

The next participant wondered if section 469 could have been avoided by more prompt action from the IRS on partnership classification or profit motivation issues. Professor Koppelman responded that earlier enactment of such changes as the ACRS modifications and repeal of the ITC might have avoided the need for section 469, but he doubted that regulations alone could have prevented the proliferation of tax shelters. Mr. Tucker responded that the real problem was not the classification regulations but the failure of the IRS and Treasury to focus on basis issues. The participant noted that these are audit-level questions, and that the tax shelter industry could not have thrived had the regulations not been skewed in the direction of finding a partnership.

Another participant suggested that without deduction of the inflationary component of interest, it would be difficult to develop shelters. He asked if dealing directly with the interest deduction might eliminate the need for some of the other provisions designed to get at tax shelters. Professor Koppelman agreed but noted that a comprehensive indexing package would also be very complex.

The next participant suggested that marginal situations should be dealt with in the courts rather than in the Code. Professor Koppelman noted that good regulations can also be used to deal with marginal situations.

Another participant proposed doing away with the at-risk rules and with partnership basis derived from nonrecourse debt. He also noted that section 469 affects two types of taxpayers: investors and people in the real estate industry. He suggested that the former group will be out of real estate shelters in a few years and that it would be fair to allow the latter group to put all income associated with real estate into one basket. Mr. Tucker supported this idea but noted that combining service income with passive losses from real estate could lead to perceived abuses.

The final comment came from a participant who referred back to the proposal to combine sections 163(d) and 469. He observed that individuals with only service and portfolio income currently have no incentive to participate in tax shelters whereas this proposal would make tax shelters attractive to them. Professor Jones responded that other changes in the law that already have been enacted should prevent a resurgence of abusive tax shelters.

ENDNOTES

[1] Professor Koppelman's Conference Paper is reproduced in Part I (P-1).

[2] Professor Jones's Conference Paper is reproduced in Part I (Q-1).

[3] Mr. Tucker's comments are reproduced in Part I (R-1).

Employee Benefits: Statutory Simplification

Session 7: Friday Morning, January 12, 1990

Presenter:	David J. Kautter
Moderator:	Richard Katcher
Panelists:	Harry J. Conaway
	Susan P. Serota*

The moderator, Richard Katcher, noted that following the enactment of ERISA in 1974, "Congress began a period of constant activity" in the employee benefits area. Through 1989, fourteen acts have amended ERISA, and numerous regulations, rulings, revenue procedures, and announcements have added to the complexity faced by taxpayers and practitioners. The focus of this panel was on how to reduce that complexity.

David J. Kautter[1] began by noting that three sets of rules govern employee benefits: qualified plan rules, rules dealing with welfare (fringe) benefits, and non-qualified compensation rules. He devoted most of his talk to the most complicated rules--those related to qualified plans.

He cited three primary causes of the current state of these rules. The first is "relentless layering of change upon change without an effort to integrate all those subsequent changes into the preceding changes." The second is obsession with theoretical purity by policymakers, especially with regard to equity and non-discrimination. The third is practitioners and their clients, who desire flexibility, which in turn causes complexity.

Mr. Kautter's approach was to offer proposals that reduce complexity while retaining as much of the underlying principles of current legislation as possible; that is, his proposals would retain the long-standing tenets of the area such as plans, trusts, participation rules, and vesting.

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Richard Katcher is a partner in the law firm of Baker & Hostetler in Cleveland.

Harry J. Conaway is a principal of Mercer Meidinger Hansen in the firm's Washington, D.C. office.

Susan P. Serota is a partner in the firm of Winthrop, Stimson, Putnam & Roberts in New York.

Two structural changes were included among Mr. Kautter's proposals. The first was to eliminate old Code names (profit sharing, pension, and stock bonus plans) and retain ERISA names (defined benefit and defined contribution plans), thereby describing qualified retirement plans with a single set of terms. The second was to segregate leveraged ESOPs from the retirement plan provisions. This would collect all of the ESOP rules in one place and eliminate these special rules from the retirement plan provisions where they add complexity to already complex rules.

As to plan qualifications, Mr. Kautter proposed repealing the top heavy rules. Rules passed since 1982 affecting compensation limits, vesting schedules, and Social Security integration make it less likely that any plan can skew benefits to favor the highly paid. Thus the marginal contribution of the top heavy rules to equity is now outweighed by the marginal contribution to complexity.

Mr. Kautter also proposed repealing the minimum participation rules of section 401(a)(26), which are accompanied by 118 pages of regulations. Congress could have accomplished its goal more directly and simply by changing the existing comparability rules.

With regard to benefit accrual rules, Mr. Kautter proposed eliminating the actual deferral percentage test in 401(k) plans in which all employees (over age 21 and with one year of service) are eligible to participate. The need for this test, which was designed to prevent highly paid employees from contributing large amounts relative to rank-and-file employees, has been mitigated by the existing dollar limit of $7,000 per year (indexed). Relatively little discrimination can occur with a fairly low dollar cap.

Mr. Kautter also supported repeal of the 403(b) annuity rules, which allow employees of tax exempt organizations to defer compensation on a tax exempt basis. These employees could make contributions to 401(k) plans with similar benefits.

Another proposal regarding benefit accrual rules would be to eliminate the ability of employees to make after-tax contributions to qualified plans. Other alternatives such as annuity contracts exist; there is no need to allow these contributions to qualified plans. Mr. Kautter also suggested eliminating permitted disparity rules, which give an employer credit for the employer's contribution to Social Security. He conceded that this proposal might cause some employers to terminate their plans.

Mr. Kautter offered two proposals regarding plan participants. The first would be to eliminate income averaging for lump-sum distribution from qualified plans. The rules are complicated, the option requires an analysis from individuals who often cannot afford to make a mistake, and lump-sum distributions are inconsistent with the notion of wage replacement. The second proposal would be to eliminate most of the restrictions on rolling over distributions from a qualified plan to either an IRA or another qualified plan.

Finally, Mr. Kautter discussed several proposals regarding fringe benefits. Several might be eliminated, including the section 101(b) $5,000 death benefit exclusion and the group legal services exclusion. The section 127 educational assistance exclusion should be made permanent, since it is simpler than the trade or business deduction available to most

taxpayers who benefit from section 127 plans. In addition, the $50,000 group-term life insurance exclusion should be increased.

With respect to non-discrimination tests, Mr. Kautter suggested that design-based tests are preferable to usage-based tests. Design-based tests could eliminate most discrimination as well as the complexity associated with usage-based tests.

In summing up, Mr. Kautter emphasized the importance of reducing complexity in the employee benefits area. Failure to do so will result in increased noncompliance, much of it unintentional.

The first panelist, Harry J. Conaway,[2] began his comments by raising the issue of the level at which we desire to achieve simplification. For example, simplification can be achieved in the written law, in the regulations, or in the practical effect on plan sponsors and taxpayers.

Second, he noted that trade-offs may be necessary. For example, simplification and flexibility may be incompatible; that is, simple rules may not fit existing practice and therefore may be more disruptive than complex rules. Likewise, special transitional rules may be fair, but they can make practice more difficult for plan sponsors and taxpayers. In addition, simple rules may not achieve horizontal and vertical equity.

It is also important to note that some complexity in this area affects only plans that operate at the edge of permissible practice. Sponsors could choose to operate in the mainstream and thereby elect out of much of the complexity.

Part of the complexity in the benefits area arises from the high tax expenditure costs. It is reasonable to expect that Congress would want to devise rules to target the tax expenditures at the intended beneficiaries. Multiple objectives also contribute to complexity.

Mr. Conaway advocated explicit recognition of the nature of the two approaches to achieving non-discrimination (design-based testing versus annual or usage-based testing) followed by a debate concerning which approach will achieve the non-discrimination objectives and minimize the compliance burden. In some cases, it should be noted that the compliance burden falls on the plan sponsor (section 415(e), for example) while in others it falls on the participant (section 4980A, for example).

In closing, Mr. Conaway discussed a proposal that had been considered at Treasury during the development of the Tax Reform Act of 1986. In short, the proposal was that Congress, Treasury, and the Labor Department join together to create a set of prototype qualified plans. These would be the only plans available to employers. Flexibility would be limited, but complexity would be greatly reduced.

The second panelist, Susan P. Serota,[3] began by noting some special aspects of the employee benefits area. First, it is affected by numerous laws other than the tax law and by a number of agencies. Second, plans are important to our economy because of the

significant value of the assets they control. Third, there is a natural tension between the goals of a national retirement policy and the cost to subsidize it through qualified plans.

Ms. Serota recounted how her own employee benefits practice has grown over the years as the laws have become more complex and the stakes have become more important for all the parties. She noted the difficulty of practicing in an area of constant change. Complexity in this area comes from three sources: incremental overload, the obsession to chase tax abuse, and the desire of practitioners and plan sponsors to retain flexibility. No number of standard or prototype plans will satisfy everyone.

Ms. Serota noted that Mr. Kautter's proposals would help address the first type of complexity. The second and third sources are more difficult to address. Eliminating complex rules would simplify the Code but possibly at the cost of equity. In addition, severely restricting flexibility may prevent employers from meeting their goals (such as rewarding their most productive employees).

The top heavy rules are an example of a provision that should be repealed. The ABA has called for the repeal of these rules because the amount of complexity required to differentiate and regulate top heavy plans is not worth the small increment in the minimum benefit provided for the workers it affects. Congress could accomplish the same goal more simply by mandating a minimum pension accrual or by raising taxes or increasing Social Security benefits.

Likewise, the minimum participation rules of section 401(a)(26) should be repealed or amended. The original purpose of these rules was to stop the proliferation and continued existence of individual defined benefit plans. However, they create complexity for many plans that were not targets of the original legislation.

Ms. Serota concluded by noting that real simplification requires employers to be willing to live with less flexibility in plan design and for the Government to be willing to live with less equity in benefit delivery.

Mr. Katcher then called for questions and comments from the floor. The first comment came from a participant who challenged Mr. Conaway's notion that we need to think about for whom we wish to eliminate complexity. He noted that if we eliminate complexity at any level, we free effort.

The next participant observed that the private pension plan system has been very successful in meeting public goals. However, the complexity of the law has encouraged many small businesses to terminate plans. It may be necessary to provide incentives for the owners of these business to reinstate or provide plans.

Another participant expressed concern for the complexity faced by an individual who is retiring and trying to decide which option is best. He also noted that much of the complexity for plans comes from sources other than the tax law. Integration of all these rules is needed. Finally, he observed that it is critical to reduce complexity in the employee benefits area now, before a national health care system is added.

Mr. Kautter's proposals were praised by the next participant. However, she criticized Mr. Conaway's suggestion of prototype plans. The problem is not with plan documents, she stated, but with understanding the rules for implementing and operating plans. Further, she questioned the ability of Treasury to write reasonable regulations.

The final participant referred to the benefits area as a "major disaster area." He stated that a complete overhaul is needed, with particular attention to the problems of small businesses.

Mr. Katcher then called for final comments from the panelists. Mr. Kautter stated that the difficulty of reducing complexity is that the rules in the statute are based on good intentions, and it is therefore difficult to challenge them on a theoretical basis. However, if we are to have a pension system that is sound, some simplification must be achieved.

ENDNOTES

[1] Mr. Kautter's Conference Paper is reproduced in Part I (S-1).

[2] Mr. Conaway's comments are reproduced in Part I (T-1).

[3] Ms. Serota's comments are reproduced in Part I (U-1).

LUNCHEON ADDRESS--JANUARY 12, 1990

FRED T. GOLDBERG, JR.*

You know, I've talked on a fair number of occasions about the lengths of regulations and argued vociferously for limitations on the number of pages. And I have a confession to make: I was always the worst basketball player in school, and I'm telling you, folks, I'm here to say short is beautiful.

Very briefly, I'd like to comment on the role of the Commissioner of Internal Revenue. I strongly believe that the Office of the Commissioner--indeed, the entire Internal Revenue Service--has as its first and foremost job to speak for and represent revenue agents and the small practitioners: the "Joe Six-packs," little folk out there trying to deal with the tax system. That is a critical part of the job, and that is one reason why the Commissioner should carry as heavy a club as possible in dealing with problems like complexity and the burden on the taxpayer.

Before giving what really are a number of random observations on the subject of simplification, I'd like to thank both the ABA, the AICPA, Stewart Dunn, Don Summa, and all the folks who put this conference together. This is a vitally important subject to the future of the tax system and to the future of tax administration. And I think that you have made a major contribution in the content of what your panelists and speakers have laid out.

More important, you have made a contribution by making clear that the question of simplification, the question of burden, is now a legitimate, out-of-the-closet subject that we have to consider whenever we review a ruling, a regulation, a revenue procedure, or a piece of legislation. The mere fact of making simplification a subject that has to be addressed is a very important contribution to the process.

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Mr. Goldberg earned his bachelor's degree form Yale University (1969) in economics. He earned a law degree from Yale Law School (1973), where he was an editor of the Yale Law Journal. From 1971 to 1973, Mr. Goldberg served as an instructor of political science and economics at Yale College and was also assistant dean of Calhoun College and Yale University.

As I said, I have a number of somewhat disconnected thoughts on the subject. The starting point is, at least from my perspective, that simplification comes in several guises and complexity comes in several guises. It's important to keep each of them in mind as you address any particular subject.

The first guise is substantive complexity. What do the rules mean? How hard is it to figure out what the rules are? How hard is it to work through the section 752 regulations just to figure out what the substantive rules are in trying to address what you ought to be doing and the consequences of the transactions you enter into?

Transactional complexity, I think, is a separate level of inquiry. What is the impact of a given set of rules on a series of commercial transactions? What are the transaction cost implications of any particular set of standards? We are working on the 1031 regulations. Well, if you believe that Congress believes that "like kind" exchanges are an appropriate form of transaction, what is your job in terms of the barriers you either create or the barriers you take down, and how does it affect the transactional ease of getting a like-kind exchange done? What do you think about accommodation parties? What do you think about escrow arrangements? How do you think about the transaction cost implications of the rules you adopt?

At a third level, the complexity discussion has to do with administrative complexity, the recordkeeping burden, and the documentation burden. What are we requiring of taxpayers, and what material are we requiring our revenue agents to deal with in assessing compliance with the law? Each of those three levels plays differently, depending the subject you're talking about and the kind of guidance you're trying to provide.

A second area I refer to as the "common myths." One of the traps you can fall into when talking about this subject is the "Have you stopped beating your wife" question. And the questions run: Do you really want to give up revenue to achieve simplicity? Do you really want to give up certainty and clarity to achieve simplicity? Do you really want to give up fairness to achieve simplicity?

You can understand that debate, and to some extent those are very real questions. But those apparent quandaries may not be real. I think that from Ken Gideon's comments about revenue, looking in the real world at the kind of issues we are addressing, it is crystal clear that simplification comes in both flavors, as Ken put it. It can be revenue-raising; it can be revenue-losing.

Let me comment on a different aspect of revenue. I believe we have for some time equated detailed, elaborate, well-honed rules as the desired tool--the tool of preference--in dealing with abuses, loopholes, and anomalies in the tax system. My own personal belief is that if you look back at the impact of a lot of those detailed, elaborate, cumbersome rules, you come to the conclusion that they may well not have achieved the revenue-preserving effects they were intended to accomplish.

And I think that those who are practitioners of the mysterious art of tax planning and creating cutting-edge transactions, financial products, and the like will tell you that

the brighter the lines and the more the lines, the more likely it is you're going to find one of those little holes to go down and never reappear. So I question the assumption that elaborate, detailed rules are synonymous with closing loopholes and solving revenue problems.

The same thing can be said about certainty. It is not at all clear to me that a detailed, elaborate set of rules and provisions is necessarily synonymous with certainty. I credit Gordon Henderson with a wonderful concept. He wrote a wonderful paper called "Hyperlexus and the Law of Ambiguity" in which he made a reference to the law of conservation of ambiguity. It's a great notion because it conjures a very clear vision. If you have one rule, one line, there are questions on both sides. Well, the more rules you write and the more lines you draw, the more sides to the figure, the more situations you are going to have where there is uncertainty and there is ambiguity. I question the basic premise that more rules assures greater certainty.

Ken mentioned yesterday that Mike Graetz has been quoted as saying that fairness and simplicity are opposite ends of the seesaw. That's an important idea to talk about, too. I will confess that in some respects, that's a harder one to think about because to me, the fallacy in the logic isn't as immediately apparent. But the analogy that I would draw is to what the economists would refer to as a "public-good problem." To put it in its simplest terms, your fairness is my overhead. When you analyze the question, that you are providing certainty to three taxpayers or providing fairness to three taxpayers but the net effect of that is that tens and tens of thousands of taxpayers have to spend hundreds of thousands of hours and millions of dollars grinding through a bunch of rules that turn out to have no application, it seems to me that the notion of certainty and fairness becomes much more opaque.

That was a point that Ken made yesterday, that the eighty little pieces of legislation that sound fair, reasonable, or appropriate in the abstract turn out, when added up, to lay an enormous burden on the rest of the community. That spillover cost, it seems to me, makes the choice between fairness versus simplicity or certainty versus simplicity a lot less clear than some would have it be. I am not as persuaded by those myths or those choices as others.

Pushing that analysis a step further, we are all trained to think about specific cases, specific questions, specific issues, specific taxpayers. It's important to step back and look at the tax system as a whole and to ask ourselves very seriously the question of what is the impact of the cumulative burden we are placing on the American taxpayer (whether you're talking about a low-income individual or a Fortune 50 company). If you conclude that the cumulative burden we are placing on the system--not just through legislation and regulations, not just through how we audit taxpayers--and you look at all of that cumulative weight, you can get very troubled by where our income tax system is going.

If you are troubled by that idea, it may change how you deal with these equations and how important simplification, the shortcuts, and lifting the recordkeeping and reporting burden are to you. My personal judgment is that the tax system does have serious problems in this regard, and that because those problems are serious, the tradeoff says

you ought to be paying more attention to lifting the burden, making it easier to comply in what is essentially a voluntary compliance system.

I'd like to talk about prospects for progress, and I'd like to start with my friend Ken. With all due respect to his predecessors--and I've known a number--I think the system is uniquely fortunate right now that Ken comes to his job with experience as IRS chief counsel, which makes him sensitive to issues of burden, administrability, and how the system is really running out there. It is a personal pleasure to work with him, and I think that he brings to his office a remarkable sense of the preservation of the system. We're all very fortunate for it.

As I said before, the fact is that complexity is on the table. It is now a legitimate subject to discuss. You've got to ask the questions. And I believe that, in and of itself, is going to have a significant, positive impact.

I've stayed away from legislative matters. That was covered yesterday, and I will forego all of my temptations to bash the Congress and will really move on. There is a very important issue that we need to think about in terms of taking the chain off. If you look at the legislation that's being enacted today, you frequently see (notwithstanding the statute and all the legislative history) language such as "Treasury should carry out congressional intent,"--whatever that is. I believe that does not mean simply to write regulations to be sure that every loophole is stitched up tighter than a drum. I think it also means something else.

I do not believe the Congress of the United States intends to pass statutes that are unadministrable, unworkable, and incomprehensible. I believe in the context of delegated regulatory authority and the inherent rule-making authority in section 7805, we have much broader latitude to write regulations that help assure the administrability, comprehensibility, and workability of the statutes Congress passes. I think we have a lot of authority, and I think it's an authority that we are making every effort to use.

One of the things you learn quickly at the Service is that what's measured moves. That basic axiom of Management 101 has an application here. To the extent we attempt to measure and pay attention to the burden we're placing on the taxpayer (the transaction costs implicit in the rules we write) we're going to have to deal with it. And quantifying that burden is hard-to-impossible. I understand all that. But the effort to measure, the effort to deal with it, is an essential ingredient to dealing with the issues you folks have been talking about.

This is a process of marginal change and marginal improvement. Or you can talk about it as an effort at radical change and a significant reversal in how we are doing business. Certainly, marginal change is appropriate. There are areas where marginal improvement is desirable and achievable, and I think we're going down that road.

But I've got to say that we are not brain surgeons. If we slip, it just doesn't matter that much in a lot of respects. We ought to take some chances to do some things very differently from the way we've always done them. We ought to be willing to take that

plunge. It isn't going to bring the world to an end. I think we have to be sensitive to the revenue issues. If you do build a big hole that way, it is unacceptable, it's a nonstarter; but subject to that qualification, we can do things very differently and we should do things very differently.

You know, one of the great treats of being the Commissioner is spending a lot of time on the rubber-chicken circuit talking to small practitioner groups and chambers of commerce and all that stuff. And I always have this standing joke. I say, "You know, we really believe in simplification, and when these pointy heads from the"--excuse me, Your Honor--"New York State Tax Bar come in and talk about simplification, you're tempted to ask them to help. But you know if you ask those suckers to help, those 400-page regulations are going to be 800 pages before they're done." It's sort of like academics, Don.

I have a public confession to make: We have talked to some folks in the New York State Bar about this issue, and I am here to publicly eat crow. We had asked them to look at a number of projects. I gather they circulated the draft to you of their rewrite of the 752 regulations. They take a rather hefty package and get it down to, I don't know, fifteen or twenty pages. Now they left out the preamble and introductory material, so their draft is destined to be forty, but they don't know that yet. But it is a credible, workable effort at taking a difficult subject and trying to say the same thing differently and in a manner that's shorter, easier to read, and hopefully more workable as far as revenue agents and the world at large is concerned.

Now, I haven't gone through the product. I do not know where it's going to lead us. But I think what's important is that it is a real effort. And I think it's important that we start to serve up those kinds of questions. Whether it's in this product or in a number of the projects that Ken alluded to where we are making this kind of effort, it's beyond the talk stage. It's a question of serving it up and making our decisions.

If it turns out that kind of simplicity leads to rampant uncertainty, rampant inequities, or significant loss of revenue, that's fine. That's what we learned. And we're stuck with what we've got. But at least we know that's what we've got and why we've got it. And I think that making that effort is so important.

I'd like to switch gears for a second and talk about information returns. When we talk about simplification, at 300 bucks an hour it's one thing. But there's a different level at which all of this stuff works. I know TRA '86 is everybody's favorite whipping boy with respect to complexity. But if you look at the impact of legislation starting in 1982 and culminating in 1986, you see something very remarkable. What is happening is obviously the simplification associated with relieving lower-income folks from the burden of filing. If you don't have to file, it is a real world, human being simplification.

More important, based on our preliminary looks, it appears that 40-plus percent of the American taxpayers now file tax returns based solely on information return documents. It doesn't include K-1s, which no one would think of honestly as an information return document. It doesn't include broker transaction-reporting documents. But the point is, you

can't overlook the importance of that fact. Because what that says is that for 40 percent of those taxpayers out there, you can get that information returns program working properly, which means that you're getting timely, accurate, readable, and understandable information to those taxpayers, so that their filing responsibility is largely transcription. That is, I believe, a profoundly important breakthrough in the system if what you're interested in is simplification.

Will Nelson made a comment yesterday that I want to mention. He said, "You know, the Service is at its limits in terms of its ability to transcribe, process, and use information return documents." I believe there is another important aspect of the information returns program, and it is not our ability to generate a "gotcha" notice. It's the ability of taxpayers to get the kind of information that lets them voluntarily comply up front. And while our ability to process the information and use the information is obviously very important, we shouldn't lose sight of the fact that the fundamental reason for that program is to make it easier on the taxpayer. It's a reason why we should be working vigorously to be sure the program is working.

As some of you know, Treasury and the Service jointly have under way a project looking at partnership reporting, to see if we can't make partnership reporting--at least at the larger partnership level, more of a true information-reporting system where folks are getting coherent, easy-to-use information off their returns.

When you listen to taxpayers and practitioners talk out there, their biggest complaint is they cannot read the 1099s well enough to figure out what the hell is even being reported. What should we do to make that system work better, recognizing that we can no more willy-nilly impose a burden on the payor community than we can on any other group of taxpayers but appreciating the importance of getting good, sound, usable information to taxpayers.

Another area that is worth mentioning--and it's an observation I have after six months--is that there are many structural imbalances in the IRS. One of the imbalances that is most troublesome to me is that our automated ability to initiate contacts with taxpayers has far outstripped our ability to respond to those taxpayers when they choose to reply.

It's important for us to begin to think about everything we do to be sure we try to re-establish that balance. Our systems are limited. We have to invest in systems modernization to put us in the position to find that balance. But it reflects a kind of thinking that is very important. You start with regulations like 752s and 368s and all that stuff. Those are important subjects, but they are a subset of a broader subject, which is the continued ability of the taxpayer to comply at any level in our system. That's the biggest challenge we face, and that's what we ought to spend our time on. Thanks.

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MR. SUMMA: Thank you, Commissioner Goldberg.

Fred, I think the applause spoke for itself. We heard some comments that I personally, and I think all of us, found very refreshing and encouraging in terms of where we are going from here, and we all look forward to the implementation of them.

Fred has kindly agreed to accept any questions from the group, and I'll let you field them, Fred. You don't need my help.

QUESTION: A question either for you or for the Assistant Secretary to test your commitment to simplification: would you recommend to the President that he veto any piece of tax legislation that does not involve a substantial net simplification of the system? This leads us into our discussion for this afternoon.

MR. GOLDBERG: Absolutely not.

You know, this kind of discussion is fun, and it is fine to have. The point that Ken made is right on the mark. Obviously, when you are talking about macroeconomic policy, investment policies and the unseemly high cost of capital in this country, tax policy has to be responsive to broader concerns. Taxes don't run the world; they can't. The only point you can make is a point that I believe Mr. Gideon has made as effectively as it can be made: Do it, but do it simple, don't do it hard. That is the proper role for the Internal Revenue Service. Economic policy takes precedence. In the context of tax legislation, addressing economic policy again, the object is if you are going to do it, that's fine, but do it as best you can and in administrable fashion.

QUESTION: Fred, I think you are right on the mark with Ken in your new initiative. Those of us who have been in the business for a long time remember that there was a time when tax practitioners gave opinion letters on controversial issues, and I note that lately when there is difficulty getting a quick response from the Service, the practitioners have started giving opinion letters instead of waiting twelve or eighteen months. That may be the result of simplification of regulations as well, and I find no difficulty in ten people giving an opinion letter rather than having an extra thirty pages of regulations.

MR. GOLDBERG: I agree with you, and I think that the role of the practitioner is very important. One of the things you get when you talk about simplification is that if you do all this stuff, folks are going to skate to the edge, there are going to be touchy-feely rules and unanswered questions, and folks are going to rip the system off to beat the band. That, probably more soberly stated, is a concern that you obviously have and we need to be sensitive to it, but I think you need to remember we are living in a world where there is compound interest, as opposed to ten years ago when it was simple interest; we are living in a world with a substantial understatement penalty. I am willing to place my faith in the practitioner community. I think that is where it belongs.

QUESTION: I was just wondering, from your standpoint as Assistant Secretary, in terms of the training of the members of staff on regulations, is there any component of their

training--I don't even know if they have training--that allows them to start having a sense of the line between being technically correct and being practically useful?

MR. GOLDBERG: That is a line that all of us are struggling to find; I wouldn't limit trying to find it to the folks in the Treasury and the Service. I think it is and should be an open process. As you know, the Treasury staff consists entirely of folks who have had private-sector experience. Increasingly the Service is hiring folks with private-sector experience. Folks who are coming to the Service directly out of law school are hopefully having more and more frequent exchange and interaction with folks out there. And it is a concern that we are trying to pay attention to, but it is a line that all of us are struggling to find. We are moving in that direction.

QUESTION: I would like to know what is being done, or what you think should be done, at your level with agents all the way down to the field and office level who just simply do not understand cost. Some of us in this room who have referred to ourselves as "priests" in the last few days don't understand some of the complicated rules of passive losses and everything else. It is true that with '87 audits, the first ones that went through with the new law, agents in a couple of different cases did not understand the AMT and they certainly did not understand the passive loss rules. Does that mean that the laws are too complicated? And if not, what does it mean? And then what I am really interested in finding out is what the Service is going to do to deal with it. I see the system crumbling, to be very sarcastic about it.

MR. GOLDBERG: Well, there are a couple of answers to that question. One, as I said before, is that when we do this kind of stuff, we need to be sensitive to how well we can administer the law. But in terms of what we are doing about it, we have a number of initiatives under way. The rest of the world has learned that for better or worse, specialization is a necessity. The notion that all 17,000 revenue agents out there are going to have to learn the passive loss rules that would be visited upon them is a nightmare. I mean, that is "Friday the 13th, Part 8". You can't do that.

On the other hand, what you can do is focus expertise and get a limited number of agents who are expert in a number of areas, and I think you can better mine that expertise which is effectively what law firms and accounting firms do. We are reviewing the possibility of completely revamping our large case program, to deal with that kind of quality issue, and it is one that we are concerned about and are pursuing pretty vigorously.

MR. SUMMA: Fred, thank you.

Let me again thank both the Commissioner and the Assistant Secretary for being with us both of these days. We appreciate your interest in our problems.

Income Tax Complexity: Capital Gain and Loss Issues

Session 8: Friday Afternoon, January 12, 1990

Presenter:	Martin D. Ginsburg
Moderator:	H. Stewart Dunn, Jr.
Panelists:	John S. Nolan
	Norman B. Ture*

Martin D. Ginsburg[1] began the session by noting that the purpose of his paper was to address a narrow issue--the effect on income tax complexity of differential treatment of capital gains and losses--and not to consider issues of equity or economic efficiency. He concluded that a special capital gain/loss taxing regime adds significantly to the complexity of the system. To illustrate the point, Professor Ginsburg offered the following example:

> Just nine months ago, Mr. A purchased a contingent trust remainder for $20,000 from an unrelated seller. Today, A received notice from the trustee that, against all odds, both preceding beneficiaries had died early and in an actuarially unlikely order. As a result, the remainder interest Mr. A bought nine months ago has now vested. Over the next sixty days, the trustee plans to sell the trust corpus, consisting of marketable securities currently worth $100,000, and will distribute the proceeds and any unsold securities to Mr. A sixty days from now.

Questions that arise from this simple set of facts include--

(1) What is the tax treatment to A of his receipt of $100,000 from the trustees sixty days from now? What will happen to him if he promptly reinvests the $100,000, makes a good investment, and three months later sells the securities for $125,000?

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John S. Nolan is a member of the law firm of Miller & Chevalier, Chartered, Washington, D.C.

Norman B. Ture is President and Founder of the Institute for Research on the Economics of Taxation, a non-profit public economic policy research institute based in Washington, D.C.

(2) Alternatively, Mr. A, prior to the trust distribution, sells the remainder interest to an unrelated purchaser for $100,000, takes the cash, and reinvests in securities, which he sells three months later for $125,000.

(3) Alternatively, the trustee does not sell the securities and instead distributes them to Mr. A in kind sixty days from now. Mr. A holds the distributed securities for another three months, after which he sells them for $125,000.

In each case, Mr. A put $20,000 at risk and ended up after fourteen months with $125,000. In each case, the question is, Does Mr. A have ordinary income, long-term capital gain, short-term capital gain, or some mixture? Professor Ginsburg reminded the audience that his example, unlike problems in practice, includes simple facts and precise questions. Yet it clearly demonstrates the complexity associated with differential capital gain treatment. This complexity has been reduced by eliminating the capital gains rate differential.

Professor Ginsburg then turned to the question of why in 1986 Congress chose to retain in the Code all the provisions related to capital gains and losses. One reason was the anticipation of a return of a capital gain rate preference. Another was unwillingness to give up the loss limitation rules because of the "cherry-picking problem." This problem arises out of the opportunity to abuse the realization system by deferring gains and realizing losses when it would be advantageous to do so for purposes of reducing taxes.

Professor Ginsburg suggested three alternative approaches to the cherry-picking problem. The first would be to force annual recognition of all property gains and losses, whether realized or not. He characterized this solution as the "appraisers' full employment act."

The second solution would be a mark-to-market regime, in which annual recognition of gains and losses would be required for all marketable property. In this regime, as he conceived it, the concept of a capital asset is not required, other deduction limitations are preserved, gain is recognized on gift of appreciated property, and gains and losses are recognized on transfers of property at death.

A third alternative would be to preserve the realization rules but allow deduction of net realized losses on the disposition of marketable property only to the extent they exceed the taxpayer's net unrealized marketable property gains, measured at year-end.

On balance, Professor Ginsburg favored the second plan as a fairer treatment than the present loss limitation rules. It would work, however, only in a world with a single tax rate applied to all sources of income.

The first panelist, John S. Nolan,[2] noted that Professor Ginsburg had not addressed issues of economic efficiency and fairness. These must be faced, he stated, because "the role of capital gains in our income tax system is far more a matter of equity and economic policy than it is a problem of complexity."

Mr. Nolan offered a number of arguments why indexation is vital to the correct measurement of income and losses. In spite of these arguments, he recognized that indexation is enormously complex, particularly with regard to pass-through entities. It also requires adjustment to liabilities as well as to assets. Mr. Nolan therefore reluctantly concluded that indexation is too complex for an income tax system.

Purely from the standpoint of complexity, he concluded that we should not reintroduce a capital gain preference as long as the present low rates remain in effect. From the standpoint of equity, the present system may be appropriate in that it helps achieve reasonable progressivity given that capital gains are realized to a high degree by higher income classes. Mr. Nolan deferred to the economists on whether lower capital gains rates are necessary or desirable for economic efficiency. Even if a persuasive economic efficiency case can be made for a capital gain rate preference, complexity considerations argue against such a change if it can be obtained only at the price of a higher top effective rate.

Finally, Mr. Nolan considered Professor Ginsburg's suggestions for simplifying the capital gain/loss statutory structure if no capital gain preference is enacted. He argued that Professor Ginsburg's preferred plan, in which gains and losses on marketable assets would be recognized annually, would materially distort investment decisions in favor of nonmarketable assets. He therefore preferred the third plan, in which a taxpayer's capital losses would be deductible to the extent they exceed net unrealized gains on marketable property. Mr. Nolan would extend Professor Ginsburg's proposal to include losses on nonmarketable property, and he would add rules to prevent abuses. He concluded that the limited added complexity would be overshadowed by "the simplification, fairness, and economic efficiency advantages."

The second panelist, Norman B. Ture,[3] stated his belief that it is virtually impossible to assess proposals to simplify without considering the impact on incentives and disincentives confronting those who must comply with the tax law. Indeed, all such proposals should be evaluated in terms of minimizing distortions in prices and costs.

Dr. Ture attributed Professor Ginsburg's "misidentification of the problems and issues" to "the analytical context in which he and most tax policy people operate." This context is derived from the work of Henry Simons, who believed we should rely on an income tax based on the taxpayer's consumption plus the change in his or her net worth. Simons supported this formulation because of his belief that the reason for an income tax is to reduce inequality in the distribution of income and wealth.

Dr. Ture challenged this vision of an income tax. He asserted that the present tax structure is inherently biased against savings and favors current consumption. Dr. Ture proposed that we should be dedicated instead to designing an income tax that is as neutral as possible in its impact on the choice between savings and consumption. We currently, tax both the amount saved and the returns on the amount saved. In addition, the tax on capital gains, in the case of most assets, adds a third layer of tax on the same income stream. The tax deferral allowed by the realization criterion is but a "modest abatement" of that third layer of tax. Any of Professor Ginsburg's proposals, all of which would

accelerate the tax on capital gains, would be counterproductive. With regard to "cherry picking," Dr. Ture stated that it should not be seen as evil but as a "modest modification" of the bias in the law against savings and investment.

Dr. Ture concluded by stating that proposals such as those supported by Professor Ginsburg and Mr. Nolan should be evaluated in light of current concerns about the adequacy of savings and capital formation. The likely effect of these proposals is to increase the cost of saving relative to the cost of current consumption.

The first comment came from a participant who proposed adoption of the Canadian system, in which gains and losses are realized at death and at the time of a gift with no estate or gift tax. Dr. Ture expressed his opposition to a system of constructive realization of gains and losses on property transferred by gift or death. Mr. Nolan urged consideration of the plan, which might permit elimination of the existing estate and gift tax system. The basic question is whether we wish to retain a transfer tax system to achieve a further redistribution of wealth.

The next participant asked for comments regarding a three-part proposal to index the basis of capital assets acquired after enactment of the change, expand the $125,000 lifetime exclusion of capital gains on a principal residence to include any capital gains, and to require the recognition of unrealized gains over the life expectancy of any taxpayer at age 70½.

Mr. Nolan responded that he could think of no justification for adopting a system to index assets acquired after a certain date. As to the lifetime exclusion, he stated that whether one supports it depends on whether one supports Dr. Ture's concept of the tax structure or the traditional structure. Dr. Ture stated that indexing does not address the core of the problem, which is multiple taxation of an income stream resulting from savings. Indexing might be a desirable supplement to reducing the tax on capital gains, but it should not be adopted in lieu of rate reduction. Mr. Nolan added that indexing should not be adopted without compensating adjustment to debt. Professor Ginsburg suggested that the third part of the proposal could introduce substantial new complexity into the law with regard to basis adjustments.

At this point, Mr. Dunn summarized the positions of the three panel members. He stated Dr. Ture's position to be that complexity is a relatively minor factor in the issue of how capital gains and losses should be taxed; economic and other factors are more important even if the result is more complexity. Mr. Dunn stated Mr. Nolan's position to be that he would be willing to have some capital gain preference if it did not result in an increase in the ordinary income rates. He characterized Professor Ginsburg's position as "ducking the issue" by focusing only on simplification aspects.

Mr. Nolan restated his position that if a capital gain preference is reinstated and if other rates remain the same, complexity is a concern but considerations of equity and economic efficiency may be far more important. He deferred to fiscal policy experts on the last point. If, however, the top effective rate of 28 percent is increased, complexity considerations become much more important.

Dr. Ture responded that he did not want to leave the impression that he utterly disregards simplification. Simplifying bad law, however, is a waste of time and energy.

The next participant questioned whether Dr. Ture's proposal would include denying the deduction for pension plan contributions or currently taxing the benefits to future retirees. Dr. Ture responded that he would recommend neither. He stated his belief that the current provisions governing these matters conform to his prescription for neutrality. The participant then stated that taxpayers are taxed twice on income subject to Social Security. Dr. Ture agreed. He further characterized the Social Security system as a "dreadful system" that would have gone bankrupt had it been in the private sector.

Another participant agreed with Professor Ginsburg that taxing capital gains differently leads to complexity in the income tax system. However, he noted that leaving the capital gain provisions in the Code did not add transactional complexity but only complexity of language. Professor Ginsburg expressed doubt that a taxpayer making a gift of appreciated property to a charity would agree. The participant then suggested that the proposal to recognize unrealized gains on marketable assets would open evasion possibilities such as putting marketable assets into a closely held corporation with an operating business. Professor Ginsburg responded that his plan would tax the holder of the asset, whether an individual or a corporation. Dr. Ture reiterated his position that treating capital gains as ordinary income is conceptually correct only if one accepts the Simons concept of income.

Another participant supported the concept of recognition of income on property transferred at death. However, trading off recognition at death for repeal of the estate tax would be regressive in view of the relative rate structures of the income tax and transfer tax.

The next question came from a participant who asked Dr. Ture to clarify how the sale of an investment security would be taxed in his system. He responded that when the security was purchased, the purchase price would be removed from the tax base. Thereafter, gross proceeds would be included in income unless they were reinvested.

The final comment came from a participant who observed that even if the consumption tax favored by Dr. Ture were adopted, all of the papers presented at the conference would remain valid with the possible exception of the current session. It would be devoted to complexity caused by a system that is biased against consumption and in favor of savings. The roles and responsibilities of practitioners would be the same under either system. Dr. Ture responded that his system would simplify the treatment of capital gains. He conceded there would be other problems.

ENDNOTES

[1] Professor Ginsburg's Conference Paper is reproduced in Part I (V-1).

[2] Mr. Nolan's comments are reproduced in Part I (W-1).

[3] Dr. Ture's comments are reproduced in Part I (X-1).

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INVITATIONAL CONFERENCE
ON
REDUCTION OF INCOME TAX COMPLEXITY

Conference Schedule of Events

Thursday, January 11, 1990

Welcoming Comments
Mr. Arthur S. Hoffman, Chairman
AICPA Federal Tax Executive Committee

Keynote Address
The Honorable Lawrence B. Gibbs
Former Commissioner of Internal Revenue

The Budget Process and Tax Simplification/Complication
Presenter: Professor Charles E. McLure, Jr.
Moderator: Professor Alvin C. Warren
Panelists: Professor David Bradford
Mr. David H. Brockway

The Role of the Treasury Department in Reducing Tax Complexity
Presenter: The Honorable John E. Chapoton
Moderator: Mr. David G. Glickman
Panelists: The Honorable Frederic W. Hickman
The Honorable Donald C. Lubick

Luncheon Address
The Honorable Kenneth W. Gideon
Treasury Assistant Secretary for Tax Policy

Tax Administration Considerations in the Development of Tax Policy
Presenter: The Honorable Roscoe Egger
Moderator: Professor Don J. Summa
Panelists: The Honorable William F. Nelson
Ms. Jennie S. Stathis

Complexity in the Tax Legislative Process: Problems and Proposals, Role of the Congressional Staffs and Taxpayer Representatives
Presenter: Mr. Bernard M. Shapiro
Moderator: Mr. Jay Starkman
Panelists: Mr. Robert N. Mattson
The Honorable Ronald A. Pearlman

Eliminating Complexity for Individual Taxpayers:
A Revenue Loser Without a Constituency?
Presenter: Professor Deborah H. Schenk
Moderator: Mr. Donald C. Wiese
Panelists: Professor Betty R. Jackson
Mr. Steven D. Kittrell

Friday, January 12, 1990

Welcoming Comments
Jere D. McGaffey

A Practitioner's Concerns About Undue Complexity
Mr. Herbert J. Lerner

At-Risk and Passive Activity Limitations:
Should Complexity be Reduced?
Presenter: Professor Stanley A. Koppelman
Moderator: Professor Ray M. Sommerfeld
Panelists: Professor Sally M. Jones
Mr. Stefan F. Tucker

Employee Benefits: Statutory Simplification
Presenter: Mr. David J. Kautter
Moderator: Mr. Richard Katcher
Panelists: Mr. Harry J. Conaway
Ms. Susan P. Serota

Luncheon Address
The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue

Capital Gain and Loss Issues
Presenter: Professor Martin D. Ginsburg
Moderator: Mr. H. Stewart Dunn
Panelists: Mr. John S. Nolan
The Honorable Norman Ture

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