

Tax Simplification

Introduction

It may fairly be urged that our present system of Federal income taxation is unduly complex. At any rate, little in the way of simplification has thus far been accomplished by revision. Each successive act has been more elaborate than its predecessor; and the maze of administrative and judicial technicalities surrounding the taxpayer has been steadily thickening.

There is no intention to suggest that it is feasible to avoid all complexity in a scheme of income taxation. Incomes arise under such a great variety of circumstances that any reasonably equitable tax program must involve many special features and technical rules. And it must be admitted that much of the revision embodied in the present act and its supporting regulations is designed to preserve equity as between different classes of taxpayers and different types of transactions.

Many taxpayers and their tax advisers would agree with the above statement. What's most interesting about the above quote, is that it was from an article written in 1923, when the federal tax laws had only been around for ten years!¹ Thus, the complexity of the tax law is not a new problem, it just seems to have continued to become a bigger problem over the past several years.

A tax research course can serve as a good introduction to just how complex the tax law can be. Congress and the Treasury Department have been talking about simplifying the tax law for the past few years. Congress has even introduced fairly long "simplification" bills, but few of the provisions have been passed, though this may change in the current year. The term simplification means different things to different people. For example, one might think that the tax law could be simplified by eliminating part of it. However, most simplification provisions that have been introduced involve changing existing rules. This often leads to transitional rules for those taxpayers affected by the change. Also, some confuse simplification with tax breaks. The process of simplifying the tax law will not be easy. This article provides some insight to the simplification process and the issues involved in simplifying the tax law.

What is simplification?

Excerpt from "Analyzing a Call for Subchapter S Simplification" by Nellen and Karlinsky, in *S Corporations: The Journal of Tax, Legal and Business Strategies*, Spring 1991:

Simplification! It is a concept that has been bandied about like motherhood and apple pie. In the past ten years we have seen "simplification" provisions enacted into law, yet have not always had

¹ "Suggestions for Simplification of Federal Income Taxation," *The National Income Tax Magazine*, August 1923, Vol. 1, No. 7.

out tax lives simplified by them. Some of these provisions also raised revenue,¹ others added new complexities to the tax law.² Clearly, reasonable people differ as to what simplifying the tax law really means and how successful Congress and Treasury have been at doing it. One might argue that simplification is like 'love,' it is in the eyes of the beholder.

Nevertheless, certain things may be said about what simplification is or is not. For example, raising the standard deduction so that a majority of individuals no longer have to itemize is simplification for a great number of taxpayers. Phasing out itemized deductions and personal exemptions at various income levels is not simplification. Applying the same definitions consistently throughout the law (e.g. constructive ownership) adds simplicity, while using different definitions for the same word adds complexity (e.g., "small business" at Sections 1361 and 1244, and "Control" at Sections 368(c) and 1504(a)(2)). Adding parallel systems (e.g., adjusted current earnings adjustment) within a parallel system (alternative minimum tax) is not simplification in that it doubles the number of calculations needed to compute tax liability. Also, transitional rules for various tax law changes adds complexity, as do convoluted formulas (e.g., the special energy deduction for AMT that was added by the Omnibus Revenue Reconciliation Act of 1990 Section 11531). In addition, changing the tax laws every year greatly hinders any attempt at simplification in that taxpayers and their advisors must constantly wade through new calculations and transitional rules, usually without guidance from the IRS which is unable to provide regulations on all these changes in a timely and useful manner. A relevant and recent example are the "one class of stock" regulations under Section 1361 as changed by the Subchapter S Revision Act of 1982 (SSRA) which were proposed with mostly retroactive application, on October 5, 1990, eight years after the law was enacted. A more egregious example are the Section 385 regulations which after twenty-one years, still have not been issued. Another unfortunate by-product of complex tax laws are lengthy and complex regulations (e.g., regulations under Sections 469 and 704(b)). The impact of complexity on compliance is a serious tax policy concern given a tax gap of over \$100 billion per year.

In February 1990, House Ways and Means Committee Chairman Dan Rostenkowski announced that a major tax simplification project would be entertained. He solicited simplification proposals from the public and government. Major goals of this effort were the need to ease compliance burdens and ensure continued viability of voluntary compliance.³ Chairman Rostenkowski's request generated over 1000 pages of proposals to simplify the tax law.⁴

¹ The Tax Reform Act of 1984 contained twenty-nine "tax simplification provisions" (Act Sections 411 - 492) dealing with such diverse topics as individual estimated tax, alimony, at-risk rules, reporting requirement and tax court rules. These provisions were estimated to raise over \$1.6 billion in a six year period. See General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Blue Book), page 1235.

² The General Explanation to the Tax Reform Act of 1986 (Blue Book) states that one of the reasons for the Act was Congress' desire for a simpler tax system for individuals (page 6). This simpler system included an increase in the standard deduction so fewer individuals would have to itemize. However, this Act added new complexities, such as the need to categorize interest expense and distinguish between active, passive and portfolio income and expenses.

³ Committee on Ways and Means U.S. House of Representatives, Written Proposals on Tax Simplification, May 25, 1990, WMCP:101-27, page III. Referred to in this article as "the Report."

⁴ The Report contains 1164 pages of proposals.

In the Report, Rostenkowski lists several standards for evaluating simplification proposals.⁷ These standards can be grouped into the following two lists for judging whether a proposal meets the Committee's criteria for a viable simplification proposals.

I. The simplification proposal should:

- reduce mechanical complexity and recordkeeping
- reduce compliance and administrative costs
- preserve underlying policy objectives and principles of existing law

II. The simplification proposals should not:

- be a tax cut for particular taxpayers or industries
- create abusive tax planning opportunities
- cause significant changes in the tax burden among taxpayers
- require major statutory changes
- create conflicts with current revenue needs and budgetary constraints

AICPA Report

The American Institute of Certified Public Accountants (AICPA) has been involved in encouraging Congress and the Treasury to simplify the tax laws. They formed a Tax Simplifications Committee a few years back and issued a report, "Blueprint for Tax Simplification" in April 1992 (the Report). The Report listed the following problems that result from a complex tax law:

- Erosion of voluntary compliance
- Perceptions of unfairness
- Difficulty of administration by the IRS
- Compliance costs
- Interference with economic decision-making

The Report also lists various causes of complexity and how they can be avoided. The AICPA suggests that simplification can only occur if taxpayers demand it of Congress and simplification principles are followed in enacting legislation.

The Report identified the following factors as contributing to complexity. Identification of these factors was an important part of the Report because solutions that will lead to simplicity must deal with the root causes of complexity. The factors that create complexity were identified as:

- Frequent change to the tax law
- Subjectiveness (such as use of the terms, "ordinary" and "necessary")
- Lack of consistent concepts (such as rules that are contrary to traditional economic, accounting or tax principles)

⁷ The Report (see footnote 3), III - IV.

Structural complexity (such as that caused by multiple definitions for the same term, and interaction of separated Code sections such as sections 168 and 280F)
Effect on taxpayers not targeted by a particular provision (such as an individual who must keep AMT depreciation records although they may never owe AMT)
Communication complexity (such as multiple definitions for the same term such as "related party")
Computational complexity
Complexity of tax forms
Administrative complexity
Diffusion of responsibility among Congress, Congressional staff, Treasury Department, IRS, etc. with no one identified as responsible for simplicity
Inconsistent application of rules by the courts
Legal complexity
Transactional complexity and business dynamics
The legislative process itself (insufficient time given to public to review proposals and comment)

[In addition to the Report, additional information on the AICPA's simplification efforts can be found in "Prelude To Simplification: Why Taxes Are So Complex," by Starkman, *Journal of Accountancy*, May 1990.]

In April 1993, the AICPA issued a "Tax Complexity Index" to be used to determine the complexity level of proposals to change the tax law. The AICPA hoped that Congressional tax writing staffs would consider the index or something similar to it when drafting legislation. This Index is a good indicator of what makes tax laws complex and what can be done to make them simpler. The Index consists of 15 questions that result in a numerical score and five general questions. The higher the numerical score, the more complex the provision being analyzed. Questions deal with whether the proposed rule is an entirely new provision (this would rate high on the complexity index), whether tax forms would have to be redesigned, whether regulations would be needed to understand the law, how much time the IRS would have to get guidance issued, how recordkeeping would change, whether new terms and definitions would be added to the Code, whether taxpayers must make calculations just to determine if the provision applies to them, and whether the rules are understandable to the target population. The general questions include whether the benefits of the change outweigh the compliance costs, whether the change has been given adequate debate, and whether the rules has been written clearly and logically.

Recent Actions by Congress

The IRS Restructuring and Reform Act of 1998 called for the IRS Commissioner to conduct an annual study of the sources of complexity in administering the tax law. This Act also calls for the Joint Committee on Taxation to prepare a tax law complexity analysis for tax legislative provisions. This complexity analysis considers how many taxpayers would be affected by the tax law change, whether tax forms would need to be changed, whether additional recordkeeping would be needed, the costs for taxpayers to comply, and whether the provision is likely to lead to disputes between the IRS and taxpayers.

The Restructuring Act also created IRC §8022, calling for the Joint Committee to prepare a report on recommendations to simplify the IRC. This extensive report was released in April 2001 (JCS-3-01) and is available at the JCT web site (www.house.gov/jct). Despite the issuance of this significant report, within a few months following its release, Congress passed one of the most complex tax acts – the Economic Growth and Tax Relief Reconciliation Act of 2001.

Additional Causes of Complexity

The Budget Process: Budget rules in Congress have required that any tax bill be revenue neutral. Thus, when Congress provided relief to full-time real estate operators under the passive activity loss rules (Revenue Reconciliation Act of 1993), a proposal that would lose tax dollars for the government (a *revenue loser*), it also had to enact a provision to raise an offsetting amount of revenue (or enact a spending cut). In addition, the matched proposals must be in the same general area. For example, the "offsetting" change to the passive activity relief was to lengthen the depreciable life of non-residential real property. This budget requirement certainly serves a worthwhile goal in keeping the deficit from growing; the side effect though, is likely to be additional complexity to the tax law, as further explained below.

A complexity problem that results from the effect of the budget process on enacting tax legislation is caused by trying to reach certain revenue levels with a proposal. This may tend to cause the drafters to look at which version of a proposal is estimated to raise or lose the target amount of revenue, without as much concern being given to whether the provision is too complex.

Congress is out of touch: A poll of twelve members of the House Ways and Means and Senate Finance Committees (six from each political party) by *Forbes* in 1992, showed that just one of the twelve prepared their own tax return. That was Representative Bill Archer (R-Tx), who commented that he felt that he needed to know what taxpayers go through. He also commented that he thought the tax law would be less complex if more members of tax-writing committees prepared their own returns.²

How easy?

How would you simplify the tax law? Find a complex provision and think of ways to simplify it. Try the same task with a regulation. Also, is there any way for tax law proposals being discussed in the current year to be enacted in a simple fashion?

What other suggestions would you offer to Congress and the IRS to simplify the tax laws?

² "Out of touch," by Laura Saunders, *Forbes*, 4/13/92.