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# The Easy Case Against Tax Simplification

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# THE EASY CASE AGAINST TAX SIMPLIFICATION

Samuel A. Donaldson\*

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<sup>1</sup> Jeffery L. Yablon, *As Certain as Death – Quotations About Taxes (Expanded 2000 Edition)*, 86 TAX NOTES 231, 238 (Jan. 10, 2000) (quoting Leon Panetta, former White House Chief of Staff).

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“If we don’t do something to simplify the tax system, we’re going to end up with a national police force of internal revenue agents.”<sup>1</sup>

“[The Tax Code] is a monstrosity and there’s only one thing to do with it. Scrap it, kill it, drive a stake through its heart, bury it and hope it never rises again to terrorize the American people.”<sup>2</sup>

“Our income tax system has been destroyed by complexity – a complexity caused largely by well-meaning efforts to achieve theoretical purity, eliminate every real and imagined ‘abuse,’ and address nontax policy objectives.”<sup>3</sup>

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<sup>2</sup> *Id.* at 236 (alteration in original) (quoting Steve Forbes, former Presidential candidate).

<sup>3</sup> *Id.* at 238 (quoting Fred T. Goldberg, Jr., former Commissioner of the Internal Revenue Service).

## I. INTRODUCTION

Simplification of the Internal Revenue Code (Code) has long been a mantra for reformers,<sup>4</sup> but the cause has historically lacked serious support.<sup>5</sup> Voters may rightly be suspicious of political candidates promising to simplify the Code. After all, few (if any) major tax bills have achieved overall simplification of the Code in any sense of the word.<sup>6</sup> The number of words, the number of legislative and interpretive regulations issued by the Treasury Department, and the number and length of tax forms from the Internal Revenue Service (Service) all continue to grow.<sup>7</sup> In some cases, proposals for simplifying the Code appear to be mere rhetorical diversions that conceal other, more controversial objectives. Proponents of the flat tax, for example, argued that applying one rate to all forms of income

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<sup>4</sup> See Sheldon D. Pollack, *Tax Complexity, Reform, and the Illusions of Tax Simplification*, 2 GEO. MASON INDEP. L. REV. 319, 320-22 (1994). See generally *id.* at 322-34 (describing historical developments that led to the rise in tax complexity).

<sup>5</sup> See, e.g., JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 372 (1985); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267, 1307 (1990) (observing that "simplicity lacks a consensus").

<sup>6</sup> The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, is the most notable exception. By broadening the tax base, eliminating various loophole and tax shelter opportunities, and unifying the tax rates applicable to ordinary income and capital gains, the 1986 Act achieved some meaningful degree of simplification. See, e.g., Daniel Halperin, *The Randolph W. Throver Symposium Tax Reform Perspectives: Fundamental Tax Reform*, 48 EMORY L.J. 809, 810 (1999); Joseph A. Snoe, *Tax Simplification and Fairness: Four Proposals for Fundamental Tax Reform*, 60 ALB. L. REV. 61, 69 (1996). But see Michelle Arnopol Cecil, *Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses*, 1999 U. ILL. L. REV. 1083, 1137 (1999) (arguing that the goal of simplification in the 1986 Act "failed miserably"); Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261, 275 (2003) (concluding that the 1986 Act promised simplification "but failed to deliver"). Perhaps ironically, many of the simplification measures contained in the 1986 Act were short lived. See, e.g., *infra* note 324.

<sup>7</sup> The Code contains approximately 1,395,000 words, and the United States Treasury Department has issued nearly 20,000 pages of regulations containing more than 8 million words. 1 JOINT COMM. ON TAXATION, 107TH CONG., TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION AT A HEARING OF THE SUBCOMMITTEES ON OVERSIGHT AND SELECT REVENUE MEASURES OF THE HOUSE COMMITTEE ON WAYS AND MEANS CONCERNING COMPLEXITY OF THE INTERNAL REVENUE CODE 2 (Joint Comm. Print 2001). Compliance with the Code and Treasury Regulations requires many forms. For 1999 alone, the Internal Revenue Service issued 649 forms, schedules, and instructions. Imbedded within those instructions were a total of 159 worksheets. *Id.* For more on the meaning of tax complexity and simplification, see *infra* Part V.A.

would significantly ease taxpayer and administrative burdens.<sup>8</sup> However, cutting the number of tax brackets and eliminating preferential rates for certain types of income does little to make the computation of tax any easier.<sup>9</sup> Tax computation is but one line on the income tax return, and most taxpayers consult tax tables prepared by the Service that already simplify the calculation.<sup>10</sup> As other authors have suggested, the subtle objective of the flat tax proposal is to undermine the progressivity of the income tax.<sup>11</sup>

Lately, however, Congress has shown signs that tax simplification may be more than an empty political pick-up line. Section 8022(3)(B) of the Code requires the Joint Committee on Taxation<sup>12</sup> to report at least once each Congress “on the overall state of the Federal tax system, together with recommendations with respect to possible simplification proposals and other matters relating to the administration of the Federal tax system as it may deem advisable.”<sup>13</sup> In April 2001, the staff of the Joint Committee on Taxation released a three-volume report on the state of the tax system and its recommendations for simplification,<sup>14</sup> its first since the July 22, 1998,

<sup>8</sup> See, e.g., ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995); John Linder, *The Code Must Go!*, 92 TAX NOTES 851 (Aug. 6, 2001).

<sup>9</sup> See William G. Gale, *Tax Simplification: Issues and Options*, 92 TAX NOTES 1463, 1478-81 (Sept. 10, 2001) (noting the complexities inherent in a flat tax). But see Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 85 TAX NOTES 1177, 1184-85 (Nov. 29, 1999) (conceding that a proposed flat tax model “would be simpler than current law” because of the change in the individual tax base, not because of the elimination of graduated tax rates).

<sup>10</sup> I.R.C. § 3(a); see also Gale, *supra* note 9, at 1468; Jerome Kurtz, *Two Cheers for the Income Tax*, 90 TAX NOTES 811, 812 (Feb. 5, 2001).

<sup>11</sup> See, e.g., John F. Coverdale, *The Flat Tax is Not a Fair Tax*, 20 SETON HALL LEGIS. J. 285, 288-91 (1996); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2129-30 (2000); Richard A. Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731, 735 (Feb. 5, 1996).

<sup>12</sup> The Joint Committee on Taxation consists of five members of the Senate Committee on Finance (three from the Senate’s majority party, two from the minority party) and five members of the House of Representatives Committee on Ways and Means (three from the House’s majority party, two from the minority party). I.R.C. § 8002(a). The committee has significant powers to obtain data related to its duties. I.R.C. §§ 8021(a), 8023.

<sup>13</sup> I.R.C. § 8022(3)(B).

<sup>14</sup> JOINT COMM. ON TAXATION, 107TH CONG., *STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986* (Joint Comm. Print 2001).

effective date of Section 8022(3)(B). The Joint Committee Report contains no less than 127 recommendations for simplifying the Code.<sup>15</sup>

The tax simplification movement has continued to gain momentum.<sup>16</sup> Former Treasury Secretary Paul O'Neill routinely listed simplification as a top tax policy objective.<sup>17</sup> Current Treasury officials have echoed O'Neill's call for simplification.<sup>18</sup> In 2001, a

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<sup>15</sup> The Joint Committee Report suggests 127 specific revisions to the Internal Revenue Code and the repeal of more than 100 "deadwood" provisions that are outdated or superseded. See 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 10-33.

<sup>16</sup> See Robert L. Ashby et al., *TEI, ABA, and AICPA Continue to Call for Simplification*, 94 TAX NOTES 777 (Feb. 11, 2002); Heather Bennett, *Lawmakers, White House Officials Debate Tax Reform, Simplification*, 92 TAX NOTES 586 (July 30, 2001); Mortimer M. Caplin, *Caplin Calls for Fairness and Simplification in New Tax Legislation*, 90 TAX NOTES 1413 (Mar. 5, 2001); Samuel J. Dimon, *Simplification of the Internal Revenue Code*, 95 TAX NOTES 575 (Apr. 22, 2002); Robert Goulder, *ABA Tax Section Meeting - Panel Ponders Simplification of U.S. International Regime*, 91 TAX NOTES 1230 (May 21, 2001); Amy Hamilton, *Taxpayer Advocate Ruminates on New Approach to Code Complexity*, 95 TAX NOTES 644 (Apr. 29, 2002); Amy Hamilton, *Treasury Releases First White Paper on Simplification*, 95 TAX NOTES 490 (Apr. 22, 2002); Amy Hamilton, *Portman Drafting Income Tax Simplification Bill*, 94 TAX NOTES 1082 (Mar. 4, 2002); Philip J. Harmelink & William M. VanDenburgh, *An Analysis of the Treasury's First Proposal for Tax Simplification*, 95 TAX NOTES 1824 (June 17, 2002); Kurtz, *supra* note 10, at 817; Joseph LiPari, *The Flat Tax: Is It Time to Reconsider?*, 97 TAX NOTES 1744 (Dec. 30, 2002); Nat'l Ass'n of Bond Lawyers, *Tax Simplification Recommendations to Treasury on Exempt Bonds*, 96 TAX NOTES 965 (Aug. 12, 2002); Patti Mohr, *Specialists Discuss Simplification in Light of Bush's Tax Plan*, 91 TAX NOTES 867 (May 7, 2001); Pecarich et al., *ABA, AICPA, and TEI Offer Simplification Suggestions*, 90 TAX NOTES 1247 (Feb. 26, 2001); Gene Steuerle, *What Next if Not Simplification?*, 91 TAX NOTES 1755 (June 4, 2001); *Tax Code Must Be Simplified*, CHI. SUN-TIMES, July 23, 2001, at 20; Tom Herman, *Tax Report*, WALL ST. J., Nov. 21, 2001, at A1 (quoting Sen. Max Baucus, chair of the Finance Committee, who said that the simplification is "clearly needed" because "[t]ax complexity itself is a kind of tax"); Richard W. Stevenson, *Bush, After Gaining Tax Cut, is Taking Aim at Tax Code*, N.Y. TIMES, July 16, 2001, at A-1.

<sup>17</sup> See Amy Hamilton, *O'Neill Fights For IRS, Simplification*, 91 TAX NOTES 716 (Apr. 30, 2001); Stevenson, *supra* note 16; Press Release PO-209, Office of Public Affairs, U.S. Treasury Department, Treasury Secretary Paul O'Neill to the Economic Club of New York (Apr. 19, 2001), available at <http://www.ustreas.gov/press/releases/po209.htm> (last visited Mar. 10, 2003); Press Release PO-233, Office of Public Affairs, U.S. Treasury Department, Treasury Statement on the Joint Committee on Taxation Study on Tax Simplification (Apr. 25, 2001), available at <http://www.ustreas.gov/press/releases/po223.htm> (last visited Mar. 10, 2003).

<sup>18</sup> Press Release PO-3701, Office of Public Affairs, U.S. Treasury Department, U.S. Assistant Treasury Secretary for Tax Policy Pam Olson Remarks to the Tax

panel of prestigious tax scholars shared thoughts on simplification for a tax policy workshop sponsored by the New York University School of Law and Tax Analysts, a leading publishing service for tax practitioners.<sup>19</sup> The National Taxpayer Advocate cites complexity of the tax laws as the most serious problem affecting taxpayers.<sup>20</sup> In the 2002 midterm elections, tax simplification became a significant rallying cry.<sup>21</sup> Indeed, it appears that tax simplification is more en vogue now than ever before.

Like pet rocks and Cabbage Patch dolls, one can only hope that this fad, too, shall pass. While the federal tax laws (or any laws, for that matter) should be no more complex than necessary, this article will demonstrate that tax complexity is not as bad as political rhetoric leads us to believe. Specifically, this article advances four arguments. First, the forces comprising tax complexity are either inevitable or net beneficial, so calls for simplification are ultimately pointless.<sup>22</sup> Part II discusses the components of tax complexity and demonstrates that complexity is not only inevitable, as others have claimed,<sup>23</sup> but also a desirable trade-off for other, more important goals, namely fairness and efficiency.

Second, the alleged harms of tax complexity are either unproven or overstated, so the need for simplification is questionable. Part III

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Executives Institute, New York City, New York (Dec. 18, 2002), available at <http://www.ustreas.gov/press/releases/po3701.htm> (last visited Mar. 10, 2003).

<sup>19</sup> See Christopher Bergin, *Academics Ponder Inequities in Tax Code and What to Do About Them*, 90 TAX NOTES 996 (Feb. 19, 2001).

<sup>20</sup> To emphasize the seriousness of the concern over tax complexity, the National Taxpayer Advocate ranks complexity both first and second in the list of top twenty taxpayer concerns. Individual tax complexity ranks first and business tax complexity ranks second. See Amy Hamilton, *Tax Law Complexity Ranks 1st – and 2nd – Among Taxpayer Problems*, 90 TAX NOTES 140 (Jan. 8, 2001); News Release #1R-2001-02, Internal Revenue Service, National Taxpayer Advocate Releases Annual Report to Congress (Jan. 4, 2001), available at <http://www.unclefed.com/Tax-News/2001/nr01-02.html> (last visited Jan. 21, 2003).

<sup>21</sup> See Patti Mohr & Warren Rojas, *Elections Boost GOP Tax Cut Agenda*, 97 TAX NOTES 727 (Nov. 11, 2002); Robert J. Wells, *Making the Case for the Keys to the Car*, 97 TAX NOTES 437 (Oct. 28, 2002).

<sup>22</sup> The same has been said of simplification proposals in other areas of the law. See, e.g., R. George Wright, *The Illusion of Simplicity: An Explanation of Why the Law Can't Just Be Less Complex*, 27 FLA. ST. U. L. REV. 715, 718 (2000).

<sup>23</sup> Chief among these commentators is Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969); see also WITTE, *supra* note 5, at 370-73; Rob Bennett, *Complexity Happens*, 45 TAX NOTES 781 (Nov. 6, 1989); Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 2 (1974).

develops this argument. Like the first argument, however, it depends upon a critical but simple (pun intended) assumption: that the federal tax laws have become more complex over time.<sup>24</sup> In terms of volume, the mere size of the Code and of regulations promulgated by the Treasury Department has increased steadily over time,<sup>25</sup> and the number of tax forms and the total amount of lines on these forms have likewise increased. There have been an increasing number of taxpayers, which invites more unique cases clamoring for exceptions from seemingly unfair general rules. Further, as the American economy has become more global, the Code has become more complicated in response.<sup>26</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>27</sup> (2001 Act) also contributed to overall tax complexity, even while simplifying definitional issues with respect to the earned income tax credit and the income-based phaseout provisions.<sup>28</sup> The assumption of increased tax complexity does not state that the increased complexity from year to year has been linear or exponential – such algebraic precision is highly unlikely. It will be sufficient for purposes of this article that tax complexity increases over time, no matter the rate of growth.

Third, significant proposals for simplification are flawed because they either ultimately result in increased complexity or because they overcorrect for the perceived problem. Part IV examines three specific proposals contained in the Joint Committee Report: repeal of the alternative minimum tax, reform of the rules related to the taxation of capital gains, and repeal of several income-based phaseout provisions. Part IV concludes that the proposed repeal of the alternative minimum tax would represent abandonment of important policy considerations in the name of simplicity. The proposed restructuring of the capital gains rules, on the other hand, would fail to achieve simplification and actually increase tax complexity. Only the proposed repeal of income-based phaseout provisions merits

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<sup>24</sup> Other commentators use this assumption, which supports its validity. See, e.g., Gale, *supra* note 9, at 1463; Pollack, *supra* note 4, at 352.

<sup>25</sup> See *supra* note 7.

<sup>26</sup> Subchapter N of the Code, sections 861-999, relates to the U.S. taxation of nonresident alien individuals and foreign business entities, as well as the U.S. taxation of its citizens, residents, and domestic entities doing business (or having investment income from) abroad. See *infra* Part II.C.2.

<sup>27</sup> Pub. L. No. 107-16, 115 Stat. 38.

<sup>28</sup> Gale, *supra* note 9, at 1468. For a more detailed discussion of income-based phaseouts, see *infra* Part IV.C. Indeed, perhaps the added complexity brought on by the 2001 Act represents the dubious lip service Congress gives to simplification.



serious consideration, but not because of simplicity. Congress should eliminate these phaseouts because they cause improper distortions in vertical equity.

Fourth, simplicity is an overrated policy objective. This argument, set forth in Part V, goes against the consensus among scholars that the three most important criteria for evaluating any tax system (or a particular rule or set of rules within a tax system) are equity, efficiency, and simplicity.<sup>29</sup> Equity and efficiency are laudable goals, but simplicity is not itself virtuous. Simplicity may be good or bad, depending upon what results from a simple rule; however, equity and efficiency are always good. Simplification merely for the sake of simplicity is neither inherently good nor bad; consequently, simplicity is at best a questionable policy objective. Further, simplicity is perhaps best understood as a component of efficiency, another

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<sup>29</sup> Judge Sneed identified seven qualities of a just tax: (1) adequacy of revenue, meaning that the tax generates significant revenues and causes taxpayers to pay the tax sooner rather than later; (2) practicality, his term for simplicity and administrability; (3) horizontal equity, meaning taxpayers with similar incomes are taxed alike; (4) stability, meaning that revenues from the tax grow at a constant rate and do not over-tax in times of recession or under-tax in times of inflation; (5) reduced economic inequality, his term for “vertical equity,” the notion that taxpayers with more income bear a heavier burden than taxpayers with less income; (6) free market compatibility, meaning that the tax is relatively unobtrusive in taxpayer decision models; and (7) political order, a reminder that good tax laws are constitutional and cognizant of the need for separation of powers. Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 568 (1965). Judge Sneed himself assigns greatest weight to equity and practicality. *Id.* at 601.

Other commentators have used all or some of Judge Sneed’s criteria in their own analyses. See, e.g., Gordon T. Butler, *The Line Item Veto and the Tax Legislative Process: A Futile Effort at Deficit Reduction, but a Step Toward Tax Integrity*, 49 HASTINGS L.J. 1, 72 (1997); Donna M. Byrne, *Progressive Taxation Revisited*, 37 ARIZ. L. REV. 739, 747 (1995); Joseph M. Dodge, *A Combined Mark-to-Market and Pass-Through Corporate-Signer Integration Proposal*, 50 TAX L. REV. 265, 273-77 (1995); David G. Duff, *Disability and the Income Tax*, 45 MCGILL L.J. 797, 804 (2000); Barry M. Freiman, *The Japanese Consumption Tax: Value-Added Model or Administrative Nightmare?*, 40 AM. U. L. REV. 1265, 1283 (1991); Malcolm Gillis et al., *Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches*, 51 TAX L. REV. 725, 727 (1996); Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615, 631 (1998); Eric A. Lustig, *Taxation of Prepaid Tuition Plans and the 1997 Tax Provisions – Middle Class Panacea or Placebo? Continuing Problems and Variations on a Theme*, 31 AKRON L. REV. 229, 266 (1997); John K. McNulty, *supra* note 11; H. David Rosenbloom, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations*, 26 BROOK. J. INT’L. L. 1525, 1527 (2001); George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141, 153 (1999).

criterion often used in evaluating a tax. By elevating simplicity as a separate criterion on par with efficiency, simplicity receives too much attention and other important elements of efficiency do not receive enough attention. Too much emphasis on one component of efficiency also minimizes the importance of the components of equity.

The unifying theme of these four arguments is that just as simplicity is not necessarily good, tax complexity is not necessarily bad. The objective of this article is not to dismiss all simplification proposals. Indeed, a number of proposals in the Joint Committee Report are appealing,<sup>30</sup> as are those from other scholars.<sup>31</sup> Instead, this article trumpets the perspective that complexity may be better than we believe. No one likes hard laws, but we dislike unfair, inefficient laws even more. To the extent that many tax simplification proposals would undermine more legitimate objectives, it is right to question the need for simplicity.

## II. THE COMPONENTS OF TAX COMPLEXITY

The tax laws are complex for a variety of reasons. In some cases, the causes of complexity are inherent in the economic or political process. Other components of complexity represent a trade-off for

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<sup>30</sup> For example, the Joint Committee Report identifies more than 100 “deadwood” provisions of the Code that, while obsolete, have never been deleted from the Code. 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 579-93 (Joint Comm. Print 2001). As there is no benefit to retaining outdated laws, Congress should follow the Joint Committee Report’s recommendation to repeal these provisions. In addition, Congress should seriously consider recommendations that attempt to reconcile conflicting authorities. For instance, the Joint Committee Report recommends that stock redemptions triggered by divorce should be taxable to the surviving shareholder unless the parties specifically agree to tax the redeeming spouse instead. *Id.* at 265. The recommendation reconciles conflicts that have emerged between various courts that have handled the issue. *Id.* at 263-65. Subsequent to publication of the Joint Committee Report, Treasury issued proposed regulations that generally adopt the Joint Committee Report’s recommendation. *See* Prop. Treas. Reg. § 1.1041-2, 66 Fed. Reg. 40,659 (Aug. 3, 2001).

<sup>31</sup> *See, e.g.,* Lawrence Lokken, *Capitalization: Complexity in Simplicity*, 91 TAX NOTES 1357 (May 28, 2001) (recommending additional official guidance on the meaning of the term “capital expenditure”); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989) (advocating, among other things, a single “support allowance” in lieu of personal exemptions, the standard deduction, the child credit, and the earned income tax credit).

other benefits that outweigh the alleged costs of a more complicated system. These components of tax complexity make the cries for simplification ring hollow, despite their intuitive appeal. This part will address the several components of tax complexity.

### A. *Inherent Causes of Tax Complexity*

Tax complexity is inevitable. There are at least seven components of tax complexity that will always be present. Some are the by-product of the American political process and the separation of powers, while others are a reflection of the complex forces that produce and shift wealth. To the extent these factors will always complicate the federal income tax, comprehensive simplification is an unrealistic aspiration.

#### 1. Using the Tax Laws to Affect Behavior

The federal tax laws do more than raise revenue. It is no secret that they also influence taxpayer behavior. The many “tax expenditure” provisions within the Code have little to do with raising revenue or determining the proper tax base.<sup>32</sup> Tax expenditures serve as indirect subsidies. Congress is willing to forego a portion of the tax revenues by providing tax benefits as a reward for certain behaviors. One of the most significant examples, from a revenue standpoint, is the deduction for “qualified residence interest.”<sup>33</sup> Allowing a

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<sup>32</sup> The phrase “tax expenditure” is generally attributed to Professor Surrey, who first conceived that many tax preferences were in fact the equivalent of direct government payments to the affected taxpayer. See generally STANLEY S. SURREY & PAUL R. MCDANIEL, *TAX EXPENDITURES* (1985). The term is something of a lightning rod among tax scholars, however, principally because there is no consensus as to the definition or measurement of tax expenditures. See, e.g., William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309 (1972); Thomas D. Griffith, *Theories of Personal Deductions in the Income Tax*, 40 HASTINGS L.J. 343 (1989); Edward A. Zelinsky, *Efficiency and Income Taxes: The Rehabilitation of Tax Incentives*, 64 TEX. L. REV. 973 (1986). The debates continue today with as much fury as ever. See, e.g., Herman P. Ayayo, *Tax Expenditures: Useful Economic Concept or Budgetary Dinosaur?*, 93 TAX NOTES 1152 (Nov. 26, 2001); Bruce Bartlett, *The End of Tax Expenditures as We Know Them?*, 92 TAX NOTES 413 (July 16, 2001). Without taking sides in these debates, this article uses the term “tax expenditure” in a most general way: as a reference to any Code provision offering an exclusion, deduction, or credit as an incentive to engage in (or refrain from) certain behaviors or transactions.

<sup>33</sup> I.R.C. § 163(h)(2)(D). The Joint Committee estimates that the home mortgage interest deduction will cost approximately \$384.9 billion during the years

deduction for interest paid on indebtedness secured by the taxpayer's principal residence<sup>34</sup> is antithetical to the general rule prohibiting deductions for personal, living, or family expenses.<sup>35</sup> Still, the deduction is a sacred cow, politically speaking.<sup>36</sup> The express intention of the deduction is to encourage home ownership,<sup>37</sup> and the national economy reaps the collateral benefits.<sup>38</sup> Another significant incentive provision is the deduction for charitable contributions.<sup>39</sup>

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2003-2007. JOINT COMM. ON TAXATION, 107TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003-2007, at 20 (Joint Comm. Print 2002). In other words, if the section 163(h) deduction did not exist, federal revenues would be increased by \$384.9 billion over this five-year period. Again, some scholars would argue that section 163(h) is not a "tax expenditure" as that term is understood by them. For purposes of this article, however, the provision is well within the broad scope of this term. See *supra* note 32. Others agree that section 163(h)(2)(D) is a "tax expenditure" provision. See, e.g., McCaffery, *supra* note 5, at 1278.

<sup>34</sup> Interest paid on indebtedness used to acquire, construct, or substantially improve a "qualified residence" is deductible to the extent the amount of such "acquisition indebtedness" does not exceed \$1 million. I.R.C. § 163(h)(2)(D), (h)(3)(A)(i), (h)(3)(B). Interest paid on indebtedness secured by a "qualified residence" but not used for acquisition, construction, or substantial improvements is also deductible to the extent the amount of such "home equity indebtedness" does not exceed the taxpayer's equity in the qualified residence, or, if less, \$100,000. I.R.C. § 163(h)(2)(D), (h)(3)(A)(ii), (h)(3)(C). A "qualified residence" means the taxpayer's principal residence and one other dwelling used as a residence by the taxpayer. I.R.C. § 163(h)(4)(A). Thus, mortgage interest with respect to a taxpayer's regular home and a vacation home may be deductible, provided both homes meet the statutory definition of a residence.

<sup>35</sup> I.R.C. § 262(a). Section 163(h)(1) generally disallows a deduction for "personal interest," but section 163(h)(2)(D) expressly excepts qualified residence interest from the definition of personal interest. Because of its specificity to interest, there is no question that the section 163(h)(2)(D) allowance trumps the general rule in section 262(a). See generally BORIS I. BITTKER ET AL., FEDERAL INCOME TAXATION OF INDIVIDUALS 22-1 (3d ed. 2002).

<sup>36</sup> David Shakow & Reed Shuldiner, *A Comprehensive Wealth Tax*, 53 TAX L. REV. 499, 535 (2000).

<sup>37</sup> JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 263-64 (Joint Comm. Print 1987).

<sup>38</sup> Increased home ownership stimulates housing development, which employs developers, architects, construction workers, and other professionals. It also creates better job opportunities for real estate agents, title insurance companies, mortgage officers, and others. See *infra* note 449 and accompanying text.

<sup>39</sup> I.R.C. § 170. The deduction for charitable contributions is also a major tax expenditure item. The Joint Committee on Taxation estimates that the deduction for contributions to educational institutions will cost \$38.3 billion in lost revenues from 2003-2007. JOINT COMM. ON TAXATION, 107TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2003-2007, at 23 (Joint Comm. Print 2002).

These contributions clearly represent the type of consumption expenditures that are normally nondeductible, but the charitable contribution deduction serves to encourage restrained philanthropy.<sup>40</sup>

If the Code did not contain these and other tax expenditure provisions, there is no doubt that it would make more sense and be simpler to understand and to enforce.<sup>41</sup> Tax expenditure provisions not only contradict fundamental tax principles but in many cases also require additional computations and additional sets of records. In order for an individual to claim a charitable contribution deduction, for example, the individual must compute the applicable "contribution base" limit<sup>42</sup> and must be able to substantiate contributions in excess of a de minimis amount.<sup>43</sup>

There is considerable debate about whether tax expenditures represent sound tax policy.<sup>44</sup> They are hardly efficient in terms of market neutrality since their very purpose is to influence behavior. Others have also shown equitable flaws in tax incentive provisions.<sup>45</sup> But the propriety of tax expenditures is somewhat beyond the point.

Contributions to health organizations will cost another \$27.4 billion. *Id.* at 25. Contributions to charities other than educational institutions and health organizations will cost \$182 billion. *Id.* Therefore, the total projected cost of the section 170 deduction is \$247.7 billion.

<sup>40</sup> Because the deduction is limited to a percentage of a taxpayer's "contribution base" (which for most individuals equates to "adjusted gross income"), I.R.C. § 170(b), the deduction encourages *limited* (but not full-tilt) philanthropy.

<sup>41</sup> See McCaffery, *supra* note 5, at 1274; Paul R. McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27 (1978); Pollack, *supra* note 4, at 321.

<sup>42</sup> I.R.C. § 170(b)(1). Deductions for contributions to certain types of charitable organizations are allowed to the extent the total amount of such deductions does not exceed 50% of the taxpayer's "contribution base," generally defined as the taxpayer's adjusted gross income computed without regard to any net operating loss carrybacks to the year. I.R.C. § 170(b)(1)(A), (F). Contributions to other charitable organizations are allowed only to the extent they do not exceed 30% of the contribution base (or, if less, 50% of the contribution base minus the amount deductible for payments to charities described in the preceding sentence). I.R.C. § 170(b)(1)(B). These percentage limitations are further reduced (from 50% to 30% and from 30% to 20%) if the contributed property is "capital gain property" and was held by the donor for more than one year prior to the contribution. I.R.C. § 170(b)(1)(C)(i), (b)(1)(D).

<sup>43</sup> I.R.C. § 170(f)(8).

<sup>44</sup> See *supra* note 32.

<sup>45</sup> For one thing, tax expenditures in the form of deductions benefit those in the higher tax brackets, meaning that wealthier taxpayers essentially capture the benefits. See Griffith, *supra* note 32, at 352-53.

The fact is that Congress does use the Code to achieve certain social policies, and this result is almost inevitable. Is there a more effective way, for instance, to encourage charitable contributions than through an income tax charitable contribution deduction? Congress could become extreme and mandate contributions, a state-sanctioned tithing program. While forced extraction could enhance total charitable contributions,<sup>46</sup> it also may produce an inefficient allocation of contributions, to say nothing of the political unpopularity that forced extraction would foster. The charitable income tax deduction, on the other hand, encourages voluntary contributions without force. Congress loses some revenues, but Congress bets that charities will receive more in the form of taxpayer contributions than the financial support that Congress could otherwise provide to charities. The amount of deductible charitable contributions over the last several years suggests that Congress is winning the bet.<sup>47</sup> Indeed, to the extent that the tax deduction is a more effective means to encourage contributions, we can count on Congress using the Code for other social policy purposes. In short, tax expenditures are inherent in the present system because they are effective in altering taxpayer behavior. Little good results from complaining of the contributions of tax expenditures to tax complexity because Congress considers underlying social policy more important than overall tax simplicity.

While it may be politically impossible to eliminate tax expenditures, it is quite possible to simplify them. The Joint Committee Report only recommends one relatively minor proposal for simplifying the tax expenditures:<sup>48</sup> adopting a uniform definition of

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<sup>46</sup> Those not giving now would be forced to give, and taxpayers giving small amounts might be forced to give larger amounts.

<sup>47</sup> In 1999, individuals that itemized deductions claimed \$125.8 billion in deductible charitable contributions. David R. Francis, *Debating Change to Rules on Charitable Deductions*, CHRISTIAN SCI. MONITOR, Nov. 26, 2001, at 17. Given that total contributions for 2000 amounted to \$203 billion, *id.*, it is fair to conclude that the charitable deduction is likely a significant factor in deciding whether (and how much) to contribute to charity. Private contributions are essential to the operations of most charities, as federal subsidies alone would be insufficient. See *Community Solutions Act: Hearing on H.R. 7 Before the House Subcomm. on Human Res. and Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means*, 107th Cong. (2001) (statement of Sara Melendez, President and CEO of Independent Sector), available at 2001 WL 21756086.

<sup>48</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 126 (Joint Comm. Print 2001).

“qualified higher education expenses” for purposes of the various education tax incentives,<sup>49</sup> qualified state tuition programs,<sup>50</sup> and education IRAs.<sup>51</sup> Current proposals for simplification do not mean that the Joint Committee sees no possibility for the simplification of tax expenditures. The Joint Committee purposefully avoided any simplification proposals that would affect the policies underlying the current rule.<sup>52</sup> The absence of significant recommendations to simplify tax expenditures suggests that Congress cannot simplify them without impacting their effectiveness. There is no doubt that the present tax expenditures reflect a careful balance of budget reconciliation, the positive externalities sought by proponents, political compromise, and other factors. Simplifying these rules for the sake of simplicity will likely upset this balance. Since tax expenditures work,<sup>53</sup> this source of tax complexity is not only

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<sup>49</sup> There are two nonrefundable tax credits for “qualified tuition and related expenses:” (1) the Hope Scholarship Credit (a credit of up to \$1500 annually per student for such expenses paid for the first two years of the student’s post-secondary education in a degree or certificate program); and (2) the Lifetime Learning Credit (a credit equal to 20% of such expenses paid on behalf of the taxpayer, the taxpayer’s spouse, or any dependents, but not to exceed \$2000). I.R.C. § 25A. In lieu of these credits, a taxpayer can deduct up to \$3000 of such expenses, provided the taxpayer’s adjusted gross income does not exceed \$65,000 (or \$130,000 in the case of a married couple filing a joint return). I.R.C. § 222.

<sup>50</sup> I.R.C. § 529. Qualified state tuition programs allow participants to purchase tuition credits or certificates on behalf of a designated beneficiary. These credits or certificates may then be exchanged by the beneficiary for a waiver of qualified higher education expenses. Alternatively, participants in a qualified state tuition program can make contributions to a savings account plan that will be used to pay such expenses of the designated beneficiary. Contributions to a qualified state tuition program are not deductible, but earnings on such contributions are not taxed until withdrawal, if at all.

<sup>51</sup> I.R.C. § 530. A trust or custodial account created in the United States exclusively for the purpose of paying qualified higher education expenses of a designated beneficiary will be treated as an “education IRA.” Contributions to the education IRA are not deductible and may not exceed \$2000 annually per beneficiary except in limited cases involving rollovers. The \$2000 limit is subject to an income-based phaseout. No contributions are allowed with respect to a designated beneficiary that has attained age 18. To the extent amounts distributed from an education IRA do not exceed the beneficiary’s qualified higher education expenses, such distributions are not subject to income taxation.

<sup>52</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 9.

<sup>53</sup> And those that do not work can be made to work (through modification and amendment) or eliminated. For instance, when Congress determined that

inevitable but also acceptable.

## 2. Frequent Changes to the Tax Laws

Every time the Code changes, both taxpayers and the Service must adapt to the change. For a taxpayer, this means learning the new law (or paying a professional to learn the new law), analyzing its impact on the taxpayer's own situation, adjusting recordkeeping procedures as necessary, and altering planning decisions as warranted.<sup>54</sup> For the Service, it means retraining employees, adapting computer software, and revising forms and publications made available to taxpayers.<sup>55</sup> All of these adaptations require the use of important resources, usually time and money. If the tax laws did not change frequently, compliance with (and enforcement of) the federal tax laws would be much easier.<sup>56</sup>

The tax laws, however, do change quite rapidly. In the last forty-seven years, Congress has enacted more than 500 public laws that made one or more significant changes to the Code.<sup>57</sup> The relevant question, therefore, is whether change is endemic. If so, then the complexity caused by frequent change is also endemic and unsolvable. The Joint Committee Report notes that the rate of Congressional

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accelerated depreciation deductions provided an insufficient stimulus to purchase depreciable assets, Congress provided the bonus depreciation rule of section 179. *See generally* BORIS I. BITTKER, *FEDERAL INCOME, ESTATE AND GIFT TAXATION* (3d ed. 1964) at 296-97. Under section 179, a taxpayer can automatically expense (up to a prescribed limit) the cost of acquiring tangible, depreciable property used predominantly in the taxpayer's trade or business.

<sup>54</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., *STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986*, at 103-08. These costs are exacerbated when Congress retroactively repeals a new Code provision, as when section 89, introduced in 1986, was repealed in 1989 and the repeal was made retroactive to 1986. *Id.* at 64; *see also* Linda A. Schwartzstein, *Smoke and Mirrors: Tax Legislation, Uncertainty and Entrepreneurship*, 6 CORNELL J.L. & PUB. POL'Y 61, 67-68 (1996).

<sup>55</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., *STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986*, at 110-111.

<sup>56</sup> *See* McCaffery, *supra* note 5, at 1277.

<sup>57</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., *STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986*, at 63, app. D.



changes has been relatively constant since 1954.<sup>58</sup> Such a steady rate of change suggests that constant tinkering with the Code is an accepted procedure.

In theory, frequent changes to the tax laws are not inevitable. Congress could exercise more restraint in amending the Code if it chose. Given the significant turnover in Congress every two years and an economic climate that has only known rapid change,<sup>59</sup> it is unlikely that any Congress could resist implementing reforms that in its judgment will improve the Code in some way. More cynically, one might conclude that Congress regularly tinkers with the Code to keep campaign contributions flowing.<sup>60</sup> With respect to tax legislation, the old axiom is true: the only constant is change. Congress will never cure the complexity caused by change.

### 3. Complexity in the Economy

It is often said that the Code is complex because American society and its economy are complex.<sup>61</sup> A simple Code would be ineffective for more than 200 million taxpayers engaged in a wide variety of business, investment, and personal activities.<sup>62</sup> Similarly, since the federal income tax raises such significant revenues, one should expect complex rules. Professor Deborah Paul theorized that as a tax produces more revenues, complexity increases. She demonstrated this link by showing that states with the highest tax revenues have a higher volume of tax laws.<sup>63</sup> At the federal level, individual and corporate income taxes (which comprise about 89% of total federal tax revenues<sup>64</sup>) consume a far greater volume of law than excise taxes, customs duties, and wealth transfer taxes.<sup>65</sup> The Code is

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<sup>58</sup> *Id.*

<sup>59</sup> See *infra* Part II.A.3.

<sup>60</sup> Richard L. Doernberg & Fred S. McChesney, *On the Accelerating Rate and Decreasing Durability of Tax Reform*, 71 MINN. L. REV. 913, 926-45 (1987).

<sup>61</sup> See Sheldon S. Cohen, *Taming the Tax Code*, 68 TAX NOTES 1495 (Sept. 18, 1995); Marjorie E. Kornhauser, *The Rhetoric of the Anti-Progressive Income Tax Movement: A Typical Male Reaction*, 86 MICH. L. REV. 465, 519 (1987); McCaffery, *supra* note 5, at 1275; Pollack, *supra* note 4, at 335-36; Surrey, *supra* note 23, at 686.

<sup>62</sup> See Eric Kades, *The Laws of Complexity and the Complexity of Laws: The Implications of Computational Complexity Theory for the Law*, 49 RUTGERS L. REV. 403, 408-09 (1997).

<sup>63</sup> Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 173-74 (1997).

<sup>64</sup> *Id.* at 175. This percentage is based upon total tax revenues for 1993.

<sup>65</sup> *Id.* at 173-75.

complicated because of the significant revenues it produces. No set of general rules will come as close to achieving equity and efficiency as the current Code, even if the current Code is a far cry from the ideal. As long as society changes and the economy becomes more sophisticated, so too should the Code.<sup>66</sup>

#### 4. The Certainty Trade-Off

It is fair to demand certainty from the tax laws. Uncertain tax laws can unreasonably delay or even prevent efficient transactions in the marketplace. Uncertain tax laws are also easier to manipulate, which can work to the detriment of the government or taxpayers, depending on which side does the manipulating. Tax advisers are especially hungry for certainty and guidance because their mistakes can be quite costly. Even the government benefits from certainty because certain laws are easier to administer.

Certainty comes at the cost of complexity. If Congress wants to create certainty, it must write lengthy, technical statutes. If Congress wants the Treasury Department to provide certainty, it authorizes legislative regulations, and even when<sup>67</sup> Treasury promulgates clarifying regulations, they can be lengthy and technical.<sup>68</sup> Also, when

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<sup>66</sup> For the opposite viewpoint, see RICHARD A. EPSTEIN, *SIMPLE RULES FOR A COMPLEX WORLD* 21 (1995).

<sup>67</sup> In too many cases, "when" should be replaced by "if." Treasury is generally slow to promulgate legislative regulations. For example, section 736(b)(1) generally provides that payments received by a partner in exchange for the partner's interest in the partnership will be treated as distributions and not as guaranteed payments or distributive shares. Under section 736(b)(2), however, such payments allocable to goodwill or to unrealized receivables of the partnership are not subject to the general rule. In 1993, Congress added section 736(b)(3) to the Code. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13262(a), 107 Stat. 312, 541. This provision limited the (b)(2) exception to those cases where capital is not a material income-producing factor for the partnership and where the retiring or deceased partner was a general partner. Treasury has long planned to issue regulations regarding the latter requirement (that the retiring or deceased partner be a general partner), but to date has not done so. Geologically speaking, of course, ten years is the equivalent of a blinking eye, but over these ten years, taxpayers and their advisers can only guess at Treasury's likely application of this limitation. This, too, contributes to complexity.

<sup>68</sup> For example, the legislative regulations pursuant to section 1502 (relating to consolidated returns filed by an affiliated group of corporations) consume 218 pages of single-spaced, dual-column text in 4 FEDERAL TAX REGULATIONS 1049-267 (West 2002) (containing Treasury Regulations 1.1502-0 to 1.1502-100). Even interpretive regulations promulgated under the general authority of section 7805 can be lengthy and technical. See, e.g., 3 FEDERAL TAX REGULATIONS 559-630 (West 2002)

Treasury issues proposed regulations, taxpayers and tax professionals sometimes demand additional clarity.

Consider this recent example. Section 121 of the Code allows taxpayers to exclude up to \$250,000 of realized gain from the sale of a residence.<sup>69</sup> The statute imposes two requirements for this exclusion: first, the taxpayer claiming the exclusion must have owned and used the property as the taxpayer's principal residence for two of the five years prior to the sale;<sup>70</sup> and second, the taxpayer may not claim the exclusion more than once every two years.<sup>71</sup> Nonetheless, the statute confers a partial exclusion to taxpayers who do not meet the requirements for the full exclusion but who sell their homes because of "a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances."<sup>72</sup> When Treasury issued proposed regulations for Section 121 in October 2000,<sup>73</sup> however, the proposed regulations gave no indication as to what would constitute "unforeseen circumstances," saying only that the Service would apply the term as defined "in forms, instructions, or other appropriate guidance including regulations and letter rulings."<sup>74</sup> Not surprisingly, many public comments and other correspondence filed with Treasury have asked for more certainty on the definition of "unforeseen circumstances."<sup>75</sup>

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(containing interpretive Treasury Regulations 1.704-1 to 1.704-4, detailing partner's distributive share of partnership tax items and spanning seventy-one pages of single-spaced, dual-column text).

<sup>69</sup> I.R.C. § 121(a). Married taxpayers filing a joint return can in many cases exclude up to \$500,000 of realized gain from the sale of their residence. See I.R.C. § 121(b)(2).

<sup>70</sup> I.R.C. § 121(a).

<sup>71</sup> I.R.C. § 121(b)(3).

<sup>72</sup> I.R.C. § 121(c).

<sup>73</sup> Prop. Treas. Reg. § 1.121-1 to 1.121-4, 65 Fed. Reg. 60,136 (Oct. 10, 2000), corrected by 66 Fed. Reg. 14,512 (Mar. 13, 2001).

<sup>74</sup> Prop. Treas. Reg. § 1.121-3(a), 65 Fed. Reg. 60136, 60140.

<sup>75</sup> See, e.g., *ABA Tax Section Members Suggest Changes to Proposed Regs on Excluding Gain from Sale of Principal Residence*, 91 TAX NOTES 1242 (May 21, 2001) (ABA Tax Section suggesting inclusion of several unspecified personal situations as examples of "unforeseen circumstances"); *Change in Marital Status Should Be an 'Unforeseen Circumstance,' CPA Says*, 90 TAX NOTES 595 (Jan. 29, 2001) (seeking "change in marital status" generally to qualify as unforeseen change in circumstances); *Divorce is an 'Unforeseen Circumstance,' Writer Says*, 90 TAX NOTES 52 (Jan. 1, 2001) (requesting addition of divorce); *Professor Asks for Clarification of Proposed Residence Sale Regs*, 90 TAX NOTES 1320 (Mar. 5, 2001) (seeking general clarification of "unforeseen circumstances"); *Realtors Suggest Expanding 'Unforeseen Circumstances' Test of Home Sale Exclusion Regs*, 90 TAX NOTES 750 (Feb. 5, 2001)

Here we come to one of the great dilemmas of tax complexity. In response to the voluminous comments seeking more certainty, the Treasury Department had two options: define the term “unforeseen circumstances” in the final regulations in an attempt to achieve certainty or continue with the phrasing in the proposed regulations.<sup>76</sup> If it clarified the definition in the final regulations, the regulations would be more complex. Such complexity we can call “mass complexity” because it would add to the burden of many taxpayers; since the regulations would be longer and more technical, taxpayers would have to spend additional time determining whether and to what extent the additional provisions apply.<sup>77</sup> Many tax professionals would read the regulations due to the demand on professionals to stay current with the tax laws. Even less diligent tax professionals would encounter the final regulations as their clients sell their homes.

Conversely, if Treasury stuck with the language in the proposed regulations, the lingering uncertainty would create what we can call “specific complexity,” since the complexity of the proposed regulations would affect only those taxpayers who face a specific situation that may or may not be an “unforeseen circumstance.” Those taxpayers would have to seek a ruling,<sup>78</sup> often at significant

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(seeking to include health of a family member as “unforeseen circumstance” in addition to divorce and unemployment); *Writer Asks for Residence Gain Exclusion Help for Newlyweds*, 90 TAX NOTES 1622 (Mar. 19, 2001) (requesting “unforeseen circumstance” rule for newlyweds who each sell homes because of marriage); *Writer Questions Applicability of Regs on Excluding Gain from Sale of Principal Residence*, 92 TAX NOTES 1408 (Sept. 10, 2001) (questioning whether voluntary changes in employment qualify for partial exclusion); *Writer Seeks Clarification of Proposed Residence Sale Regs*, 91 TAX NOTES 907 (May 7, 2001) (asking Treasury to include divorce and unemployment as “unforeseen circumstances”); *Writers Seek Changes to Proposed Residence Sale Regs*, 90 TAX NOTES 320 (Jan. 15, 2001) (suggesting military service away from home as yet another unforeseen circumstance). This battle for certainty between practitioners and the Treasury Department is what Professor McCaffery calls “dynamic complexity.” See McCaffery, *supra* note 5, at 1275-76.

<sup>76</sup> Professor Miller calls the first option the “elaboration approach” to rule making and the second option the “social context approach” to rule making. John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1, 16-20 (1993). Miller observes that the elaboration approach is the “modern trend in rule making.” *Id.* at 17. Nevertheless, he finds the social context approach preferable. *Id.* at 77-78.

<sup>77</sup> See McCaffery, *supra* note 5, at 1291.

<sup>78</sup> Taxpayers can receive an advance ruling from the Service with respect to the federal income tax treatment of a certain transaction. These “private letter rulings” do not bind the Service with respect to other taxpayers and may not be cited as precedent before the United States Tax Court. GAIL LEVIN RICHMOND, FEDERAL

cost,<sup>79</sup> for certainty. If those taxpayers do not obtain a ruling and claim the partial exclusion, they run a risk that the Service will assess a deficiency and force the taxpayer to spend extra resources to defend the claimed exclusion. If the taxpayer loses before the Service and even the courts, the taxpayer would pay interest on the deficiency<sup>80</sup> and also, in some cases, a penalty.<sup>81</sup>

So what should Treasury have done? Should it have clarified the term “unforeseen circumstances” in the final regulations and created mass complexity, or should it have left the term undefined and created specific complexity? The normative answer is beyond the scope of this article.<sup>82</sup> In fact, Treasury chose both options. Temporary regulations issued in December 2002 offer a general rule that an unforeseen circumstance is “an event that the taxpayer does not anticipate before purchasing and occupying the residence.”<sup>83</sup> The general rule preserves specific complexity. Taxpayers selling a home due to a change in circumstances will have to determine whether the general rule will grant them a partial exclusion of the gain resulting from the sale. The temporary regulations then list seven specific events that the Treasury will deem to be unforeseen circumstances for purposes of the partial exclusion.<sup>84</sup> These events include: the involuntary conversion of the residence; casualties resulting from disasters, acts of war, or terrorism; divorce or separation; and even multiple births resulting from the same pregnancy.<sup>85</sup> By adding these safe harbors, the regulations also create mass complexity, for the regulations are longer and introduce additional terms that might become the source of further ambiguity.

This is just one example. In practice, Treasury often alternates

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TAX RESEARCH 62 (4th ed. 1990). If the Service decides to issue a ruling binding on all taxpayers, it will disguise the name of the taxpayer and other private facts and issue its conclusion as a “revenue ruling.” *Id.* at 59.

<sup>79</sup> See Rev. Proc. 2003-1, 2003-1 IRB 1, 60 app. A (fee charged depends upon type of request and affluence of taxpayer, and can range from \$275 to \$6000 for a single ruling).

<sup>80</sup> See I.R.C. §§ 6601, 6621, 6622.

<sup>81</sup> See I.R.C. § 6662 (accuracy and negligence or disregard of rules and regulations penalty); see also I.R.C. §§ 6651 (delinquency penalty), 6663 (civil fraud penalty), 6672 (attempt to evade tax penalty), 6673 (penalty for delay or frivolous court proceedings).

<sup>82</sup> For one answer to this question, see Miller, *supra* note 76, at 22-23 (favoring specific complexity).

<sup>83</sup> Temp. Treas. Reg. § 1.121-3T(e)(1) (2002).

<sup>84</sup> Temp. Treas. Reg. § 1.121-3T(e)(2).

<sup>85</sup> *Id.*

between specific complexity and mass complexity, and sometimes (as here) manages to infuse both forms of complexity. The preference for one model over another is certainly worthy of further discussion. The more important point here is that both certain laws and uncertain laws will add to tax complexity. Certain laws will create mass complexity, and uncertain laws will create specific complexity. That Treasury uses both mass complexity and specific complexity perhaps only shows that both are undesirable. Yet one or the other is inevitable. Proponents of simplification must concede that by reducing one type of complexity, they are enhancing the other.<sup>86</sup>

## 5. Judicial Gloss

Like every other body of law, the Code and regulations are subject to judicial construction. In construing the Code and regulations, courts necessarily create new rules. When, for instance, the Code simply defines gross income as “all income from whatever source derived,”<sup>87</sup> the courts must determine what constitutes “income” and then apply that working definition to the cases before them. The judiciary thus becomes another source of primary authority, adding to tax complexity. Our bias for the common law tradition, however, persuades us to accept this component of complexity gladly.

## 6. The Tax Base

An income tax is inevitably complex because there is no simple definition of “income” and no simple way to measure it. As a result, the actual tax base always reflects a “second-best” approach, and further attempts to conform the tax base to any ideal model produces more rules that further complicate the law.<sup>88</sup> A common definition states that income is the sum of a person’s consumption and the increase in that person’s net worth over a certain period.<sup>89</sup> However,

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<sup>86</sup> Professor Miller argues that mass complexity creates “indeterminacy” in the federal tax laws to the extent that it actually sacrifices fairness and undermines the overall certainty of the Code. Miller, *supra* note 76, at 27.

<sup>87</sup> I.R.C. § 61(a). The syntax and diction in section 61(a) mirrors that of the Sixteenth Amendment, which authorizes the federal income tax. By using the same phrasing, Congress intends to exercise the full capacity of its power to tax income.

<sup>88</sup> Paul, *supra* note 63, at 163; Alvin Warren, *Would a Consumption Tax Be Fairer than an Income Tax?*, 89 YALE L.J. 1081, 1109 (1980); see also Gale, *supra* note 9, at 1465.

<sup>89</sup> This is the so-called “Haig-Simons” definition of income. See Robert M.

simple bases for measuring terms like “consumption” and “net worth” are insufficient.

Currently, the Code indirectly measures “consumption” by adding most receipts into the tax base and subtracting most nonconsumption expenses.<sup>90</sup> The excess roughly resembles amounts consumed. Several authors have criticized this imperfect approach,<sup>91</sup> but any feasible measurement method will have flaws. We could, for instance, measure consumption based on credit card charges. This is a reasonable standard from a vertical equity standpoint assuming high-volume consumers incur more credit card charges than low-volume consumers. Credit card charges would be an easy measurement standard – such charges are relatively simple to trace and to verify.<sup>92</sup> For obvious reasons, the use of credit card charges is a poor measure of consumption. For one thing, not all high-volume consumers use credit cards. Also, more affluent consumers might be able to pay with cash more easily than poorer consumers – thus shifting more of the tax burden to less affluent taxpayers. Less affluent taxpayers may be more likely to use credit cards than wealthy taxpayers because they lack the resources to make immediate payment on purchased items. Further, a tax measured by credit card charges would tend to cause taxpayers to use credit cards less frequently in order to reduce their tax burdens. In order to be effective, consumption would have to account for other payment systems – necessarily increasing the complexity of the measurement. To the extent the standard for consumption is easily avoided by a

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Haig, *The Concept of Income – Economic and Legal Aspects*, in THE FEDERAL INCOME TAX 1, 7 (Robert M. Haig ed., 1921), *reprinted in* AM. ECON. ASS'N, READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 50 (1938).

<sup>90</sup> See I.R.C. §§ 61(a) (gross income defined as “all income, from whatever source derived”), 161 (permitting only deductions specifically authorized), 162(a) (allowing deduction for expenses paid or incurred in carrying on a trade or business), 212 (allowing deduction for expenses paid or incurred in the production or collection of income, or for the maintenance of property held for the production or collection of income, or for the determination or refund of any tax), 262 (disallowing deductions for personal, living, or family expenses).

<sup>91</sup> Most prominent among these authors is probably William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113, 1128-1140 (1974); *see also* Warren, *supra* note 88, at 1109-1120.

<sup>92</sup> Indeed, the federal government could even withhold tax on every credit card charge. Withholding is an efficient means to mitigate against the failures of voluntary compliance.

change in taxpayer behavior (paying with cash or check instead of credit card), the standard would have to change to make sure that revenues from the tax were constant. As others have argued, complicated regimes are necessary when basing a tax on complicated concepts like "income."<sup>93</sup>

As hard as it is to define "consumption" in a satisfactory way, it is even more difficult to find an adequate measure for the change in a taxpayer's "net worth," the other component of income.<sup>94</sup> Theoretically, increases in net worth are subject to measurement. For taxpayers with assets other than cash and marketable securities, measuring change in net worth would require annual appraisals. The annual appraisal method is too burdensome, although an annual mark-to-market for all assets might be conceptually easier to comprehend. It is also flawed because it would force taxpayers with illiquid but appreciating assets to dispose of the illiquid assets in order to pay the resulting tax liability. Further, the need for several appraisals could promote disputes between taxpayers and the Service.<sup>95</sup> To increase convenience and liquidity, the taxpayer may defer payment of tax liability until the appreciated illiquid asset is sold, exchanged, or otherwise disposed. Practitioners know this as the rule of "realization." To use the vernacular, no income from appreciating assets occurs until the gains are realized. Realization was at first a constitutional requirement.<sup>96</sup> Over time, though, the

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<sup>93</sup> See Paul, *supra* note 63, at 164-169. The need to complicate the laws in order to make them consistent with their true intent is reflected in the alternative minimum tax. See *infra* Part IV.A.

<sup>94</sup> This explains why some commentators advocate the substitution of a pure consumption tax for the current income tax. See, e.g., Pollack, *supra* note 4, at 352-55. A consumption tax would be simpler than the current income tax in the sense that there would be no need to compute the change in a taxpayer's net worth.

<sup>95</sup> In the estate and gift tax arena, valuation disputes are quite common. For recent examples, see, e.g., *Gross v. Commissioner*, 272 F.3d 333 (6th Cir. 2002); *Estate of Jameson v. Commissioner*, 267 F.3d 366 (5th Cir. 2001); *Knight v. Commissioner*, 115 T.C. 506 (2000); *Estate of Strangi v. Commissioner*, 115 T.C. 478 (2000), *rev'd in part*, 293 F.3d 279 (5th Cir. 2002); *Estate of Weinberg v. Commissioner*, 79 T.C.M. (CCH) 1507 (2000); *Estate of Dunn v. Commissioner*, 79 T.C.M. (CCH) 1337 (2000), *rev'd*, 301 F.3d 339 (5th Cir. 2002); *Estate of Smith v. Commissioner*, 78 T.C.M. (CCH) 745 (1999); *Estate of Hendrickson v. Commissioner*, 78 T.C.M. (CCH) 322 (1999); *Kaufman v. Commissioner*, 77 T.C.M. (CCH) 1779 (1999), *rev'd sub nom.* *Morrissey v. Commissioner*, 243 F.3d 1145 (9th Cir. 2001); *Estate of Mellinger v. Commissioner*, 112 T.C. 26 (1999); *Estate of Simplot v. Commissioner*, 112 T.C. 130 (1999), *rev'd*, 249 F.3d 1191 (9th Cir. 2001).

<sup>96</sup> *Eisner v. Macomber*, 252 U.S. 189 (1920) (stock dividend is not gross income to a shareholder because the dividend adds no wealth and the shareholder has no



Supreme Court itself realized that realization was not a constitutional prerequisite to income.<sup>97</sup> Eventually, the Court completely diminished the constitutional significance of realization, referring to it as a mere rule of “administrative convenience.”<sup>98</sup>

The rule of convenience is well entrenched in the modern Code. Congress codified the realization rule with respect to all sales and exchanges of property.<sup>99</sup> Congress then added several exceptions to the realization requirement.<sup>100</sup> These “nonrecognition” rules provide amnesty from taxation even though there is concededly a measurable increase in the taxpayer’s net worth and even though the liquidity notions supporting deferral are absent.<sup>101</sup> Consequently, the “rule of convenience” has made the measurement of net worth at least as

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severable benefit). The specific holding of *Macomber* is codified in section 305(a), but is subject to several statutory exceptions. See I.R.C. § 305(b).

<sup>97</sup> *Helvering v. Bruun*, 309 U.S. 461 (1940) (tenant improvements to property are income to landlord upon repossession). *Bruun* was overruled by Congress through the enactment of section 109. Section 109 excludes the value of the tenant improvements from the landlord’s gross income. Ultimately, however, the improvements are taxed to the landlord upon a taxable sale or exchange of the improved property, because section 1019, enacted at the same time as section 109, prevents the landlord from adding the value of the improvements to the landlord’s basis in the property.

<sup>98</sup> *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (interest coupons from negotiable bonds gifted to child were taxable income to parent).

<sup>99</sup> I.R.C. § 1001.

<sup>100</sup> See, e.g., I.R.C. §§ 121 (exclusion of up to \$250,000 of gain – \$500,000 for couples filing a joint return – on sale of personal residence), 351 (no gain or loss recognized on transfer of property to a corporation in exchange for stock, so long as transferor(s) control the corporation immediately after the exchange), 721 (no gain or loss recognized on the transfer of property to a partnership in exchange for an interest in the partnership), 1031 (no gain or loss recognized on exchange of “like-kind” property), 1033 (no gain or loss recognized on an exchange caused by an involuntary conversion such as condemnation, casualty, or theft), 1041 (no gain or loss recognized on property transfers between spouses, or between ex-spouses if the transfer is incident to the divorce).

<sup>101</sup> If a taxpayer sells an asset to a willing buyer, liquidity is not a concern. If the buyer pays with another illiquid asset, the taxpayer could be forced to sell the new asset to pay tax. But this forced sale occurs in most cases because the taxpayer was willing to trade the original asset. If the taxpayer has adequate notice that the exchange will be taxable, the need to liquidate the acquired asset will be a bargaining point between the taxpayer and the buyer. For example, the taxpayer may insist on additional liquid consideration in order to pay the tax resulting from the exchange. This analysis does not apply to the involuntary conversion of an asset because of condemnation, casualty, or theft. In those cases, nonrecognition of gain – subject to the limitations already set forth in section 1033 – is proper because in theory the taxpayer was never a willing party to the exchange.

complicated conceptually as the original concept that would require periodic appraisals.<sup>102</sup>

Measurement methods for both components of income (consumption and increased net worth) have proven to be inexact at best. Complexity is necessary to find the appropriate balance between feasibility and the ideal definitions of both components. Even where simplicity triumphed over equity, as with the realization concept, subsequent refinements to the rule have added complexity. Thus, the resulting complexities are inevitable.

## 7. The Legislative Process

Legislators are human, susceptible to influence and far from omniscient. Special interests, therefore, can capture some tax laws. There is no other way to explain some of the distinctions contained in the Code. Farmers disposing of livestock can in some cases qualify the resulting gains for preferential tax rates, but similar dispositions of poultry can never qualify.<sup>103</sup> As previously discussed, taxpayers engaged in certain business activities receive preferential treatment with respect to many tax items.<sup>104</sup> Other tax laws not captured by

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<sup>102</sup> See, e.g., Halperin, *supra* note 6, at 818 (noting the many complexities caused by the realization doctrine, including loss restrictions, disparate treatment of capital gains, constructive sale rules, and nonrecognition rules); Anthony P. Polito, *Fiddlers on the Tax: Depreciation of Antique Instruments Invites Reexamination of Broader Tax Policy*, 13 AM. J. TAX POL'Y 87, 100-101 (1996) (depreciation deductions complicated by realization doctrine); Snoe, *supra* note 6, at 75-76 (taxpayers' ability to manipulate realization doctrine has created complicated loss limitation, carryover, and characterization rules); David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1633-1637 (1999) (noting complexity realization causes for policymakers). *But see* Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 947-956 (1997) (arguing that application of traditional realization doctrine would simplify the taxation of new financial instruments).

<sup>103</sup> I.R.C. § 1231(b)(3). If a taxpayer holds cattle or horses for draft, breeding, dairy, or sporting purposes for twenty-four months or more, gain from the sale or exchange of the cattle or horses may qualify for the preferential tax rates applicable to long-term capital gains. I.R.C. § 1231(b)(3)(A). With respect to other livestock (but not poultry) held for similar purposes, the holding period to obtain preferential tax rates is only twelve months. I.R.C. § 1231(b)(3)(B).

<sup>104</sup> See *supra* Part II.A.1. Other facially neutral statutes may have an impure origin. Professor Graetz notes that certain taxpayers obtained tax benefits in years when related political action committees made significant contributions or gifts for the benefit of members of the congressional tax-writing committees. MICHAEL J. GRAETZ, *THE U.S. INCOME TAX: WHAT IT IS, HOW IT GOT THAT WAY, AND WHERE*

special interests are sometimes poorly written because legislators lack the time and expertise required to write a law that serves its immediate purpose and coordinates with other Code provisions.<sup>105</sup> As a result, Congress or Treasury must routinely correct for technical errors and sometimes amend new provisions after enactment to harmonize old and new laws.<sup>106</sup> The complexity resulting from interest group capture and poor drafting cannot be cured by any proposals for simplification. Even where special interests have not entirely captured a tax benefit, legislators must strike compromises that balance the needs of the special interests against opposing forces, and this too makes tax laws more complicated.<sup>107</sup>

This cause of tax complexity may not be as significant as the others, for the political process can create both simpler and more complex rules. For example, the Tax Reform Act of 1986 has been described as logrolling between special interests seeking low tax rates and those seeking a more comprehensive tax base.<sup>108</sup> If that is true, then to the extent the 1986 Act simplified the Code (by reducing the number of tax brackets and eliminating many tax preferences) and made it more complex (by enacting restrictions on the deductibility of passive losses, for instance), the logrolling process is no more likely to produce complex laws than simple laws.<sup>109</sup>

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WE GO FROM HERE 289-90 (1999).

<sup>105</sup> See Roger A. McEowen, *Recent Developments in Estate Planning Impacting Farmers and Ranchers*, 5 DRAKE J. AGRIC. L. 57, 58 (2000) (describing the need for technical corrections to the exclusion for “qualified family-owned business interests,” now codified as a deduction – not an exclusion – in section 2057).

<sup>106</sup> See Steve R. Johnson, *The Dangers of Symbolic Legislation: Perceptions and Realities of the New Burden-of-Proof Rules*, 84 IOWA L. REV. 413, 429 (1999) (“Bear in mind that technical correction legislation is always possible to cure unintended consequences of legislative inadvertence or sloppy drafting.”).

Indeed, technical correction legislation is quite common. For just a few of the many examples, see, e.g., Tax Technical Corrections Act of 1998, Pub. L. No. 105-206, §§ 6001-24, 112 Stat. 685, at 790-826; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342; Technical Corrections Act of 1982, Pub. L. No. 97-448, 96 Stat. 2365 (1983).

<sup>107</sup> McCaffery, *supra* note 5, at 1300.

<sup>108</sup> *Id.* at 1304.

<sup>109</sup> Of course, the use of logrolling to simplify the tax laws assumes that there is a constituency rolling the log to achieve simplification. Until recently, this constituency was thought to be absent. See WITTE, *supra* note 5, at 372; McCaffery, *supra* note 5, at 1307. Most likely, simplification could be achieved only by a similar union of simplification and tax cut proponents. Gale, *supra* note 9, at 1469; Warren Rojas, *Simplification Still Not a Priority, Panelists Say*, 91 TAX NOTES 1211 (May 21, 2001).

As noted earlier, however, much of the simplification achieved by the 1986

In addition, Congress lacks the ability to test Code provisions before enactment. Instead, taxpayers serve as testers, and many of them search for loopholes and other structural defects in the Code to exploit. If the resulting tax schemes succeed, then Congress must legislate once again to solve the problem. This, in turn, adds to the complexity of the income tax.<sup>110</sup> For instance, many of the corporate income tax rules in Subchapter C of the Code are reactions to successful taxpayer plans to thwart double taxation,<sup>111</sup> the signature feature of the corporate income tax regime.<sup>112</sup> If taxpayers did not seek out and exploit bugs in the Code, then legislative patches would be unnecessary. Due to the high stakes frequently involved, taxpayers have an incentive to enter into transactions designed only to avoid or reduce tax liabilities.<sup>113</sup> Increasing audit rates might deter some taxpayers from engaging in tax avoidance schemes,<sup>114</sup> but even in the past when audit rates were higher, many taxpayers were content to take their chances in the “audit lottery.”<sup>115</sup> Simplification

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Act was lost in a few short years. For example, preferential rates for net capital gains were restored in 1990. *See infra* Part IV.B.

<sup>110</sup> *See generally* Gale, *supra* note 9, at 1466; McCaffery, *supra* note 5, at 1276, 1278.

<sup>111</sup> Corporations are taxable entities subject to federal income tax on their “taxable incomes.” I.R.C. § 11. After-tax distributions of corporate earnings and profits are included the gross incomes of shareholders. I.R.C. §§ 61(a)(7), 301(c)(1). Thus, corporate earnings and profits are typically taxed twice: once at the corporate level and a second time upon distribution to shareholders. If the corporation liquidates, assets received by the shareholders in exchange for their stock are also included in gross income. I.R.C. § 331. Thus even the death of the corporation cannot evade the double-tax regime. For more on double taxation, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.03 (7th ed. 2001).

<sup>112</sup> *See generally* McCaffery, *supra* note 5, at 1276-77 & n. 37. Of course, the current President Bush has proposed elimination of the double tax by excluding most dividends paid from previously-taxed earnings. *See* Kristi O’Brien, *Challenges and Changes Keep Big Money Practices in the Bank*, CHI. LAWYER, Apr. 2003, at 8. To the extent this effort succeeds, subchapter C will lose its uniqueness.

<sup>113</sup> *See* Miller, *supra* note 76, at 13-15.

<sup>114</sup> For the arguments in support of increasing audit rates, see Jay A. Soled, *Unmasking and Deterring Congressional and Taxpayer Opportunism*, 31 CONN. L. REV. 205 (1998). *See also* Sheldon S. Cohen, The Erwin N. Griswold Lecture Before the Annual Meeting of the American College of Tax Counsel (Jan. 10, 1997), in 14 AM. J. TAX POL’Y 113, 117 (1997).

<sup>115</sup> Several of the “fixes” in the corporate tax arena came into the Code in an era of relatively high enforcement rates. Current audit rates for corporations are at record low levels. In 2001, 0.89% of all corporate tax returns were audited, compared to 1.07% in 2000, 1.51% in 1999, 2.04% in 1998, and 2.62% in 1997. *See*

proponents must consider possible bugs in their proposals; otherwise they will inevitably cause the return (and likely growth) of complexity.

### B. Complexity in the Name of Net Efficiency

Strange as it sounds, complexity can facilitate efficiency. Sometimes laws that are difficult to understand can prove easier to apply and to enforce than simple rules. Complex statutes and the delegation of quasi-legislative powers to Treasury and the Service can enhance the overall administrability of the tax laws.

#### 1. Difficult Statutory Provisions

One cannot pick up the Code and, like a summer novel, gain an understanding by thumbing through its pages from start to finish. There is no question that the Code makes for slow reading (and in many cases, re-reading).<sup>116</sup> Yet the calls to make the Code more reader-friendly<sup>117</sup> forget that the Code's intended audience is not the lay taxpayer. Congress does not write any statute, tax or otherwise, with the intention that every person affected by the statute will read and comprehend it.<sup>118</sup> Congress knows that legal professionals will most likely be the persons to read the text and interpret it for their clients. As a result, Congress can make limited use of technical jargon for purposes of brevity and to avoid both redundancy and excessive use of cross-references. For example, the Code contains the phrase "trade or business," one that must seem redundant to the untrained

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Transactional Records Access Clearinghouse, Syracuse University, IRS District Audits of Federal Income Tax Returns Filed by Corporations, at [http://www.trac.syr.edu/tracirs/findings/national/audpctcompare\\_corp.html](http://www.trac.syr.edu/tracirs/findings/national/audpctcompare_corp.html) (last visited Jan. 21, 2003). Although there appears to be no similar data prior to 1992, scholars have noted significantly higher audit rates in the 1960s and 1970s. See generally Jeffrey A. Dubin et al., *Penny-Wise and Pound-Foolish: New Estimates of the Impact of Audits on Revenue*, in SELECTED READINGS ON TAX POLICY: 25 YEARS OF TAX NOTES 387 (Charles Davenport ed., 1997).

<sup>116</sup> See 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 59-60 (Joint Comm. Print 2001). But the same can be said of many great literary works. Has anyone breezed through *Beowulf*, *The Canterbury Tales*, or *War and Peace*?

<sup>117</sup> See Pollack, *supra* note 4, at 358; Peter H. Schuck, *Legal Complexity: Some Causes, Consequences, and Cures*, 42 DUKE L.J. 1, 4 (1992) ("The Internal Revenue Code is probably the leading example of technical rules.").

<sup>118</sup> See Miller, *supra* note 76, at 36.

reader, in 321 different sections.<sup>119</sup> Since it appears so often, the attentive (though untrained) reader eventually realizes that the phrase must have some unique meaning. When the reader searches the Code for a definition of “trade or business,” however, the result is fruitless. Even the Treasury Regulations fail to provide a definition of the term. Tax professionals, though, understand what “trade or business” implies, as the concept has been litigated fairly extensively.<sup>120</sup> Tax experts know, for instance, that in order for an activity to constitute a “trade or business,” the taxpayer must have a profit motive and be engaged in the activity on a regular basis.<sup>121</sup> Tax experts also realize that because the term is undefined, Congress does not intend to give it sharp boundaries.<sup>122</sup> Thus, an activity may constitute a trade or business to one taxpayer but not to another.<sup>123</sup> Similarly, an activity may start as something other than a trade or business but over time evolve into a trade or business.<sup>124</sup> If tax experts

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<sup>119</sup> LEXIS, Fedtax Library, Code File (searched on Jan. 14, 2003). See *Commissioner v. Groetzinger*, 480 U.S. 23, 27 (1987) (noting that the term appeared “in over 50 sections and 800 subsections and in hundreds of places in proposed and final income tax regulations” at that time). A search in the Westlaw database found the phrase “trade or business” in only 265 Code sections. Westlaw Search, database “USC,” query “PR, CA (“Title 26”) and TE (“Trade or Business”)” (searched on Jan. 14, 2003). The discrepancy between the LEXIS and Westlaw searches is a concern, but regardless of which is more accurate, the point remains that the phrase “trade or business” is quite common in the Code.

<sup>120</sup> For a comprehensive discussion of the many cases analyzing whether the taxpayer was engaged in a “trade or business,” see James Edward Maule, *Trade or Business Expenses and For-Profit Activity Deductions*, [1999] 505-2 Tax Mgmt. (BNA) at A-3 to A-13.

<sup>121</sup> *Groetzinger*, 480 U.S. at 35-36; see also *Gajewski v. Commissioner*, 723 F.2d 1062 (2d Cir. 1983), *cert. denied*, 469 U.S. 818 (1984).

<sup>122</sup> See, e.g., *Scagliotta v. Commissioner*, 72 T.C.M. (CCH) 1187 (1996); *West v. Commissioner*, 51 T.C.M. (CCH) 589 (1986); *Lemmen v. Commissioner*, 77 T.C. 1326 (1981); *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

<sup>123</sup> While the taxpayer in *Groetzinger* was held to be in the trade or business of gambling, the Service declared that a recreational gambler with no expectation of profit was not in the trade or business of gambling. Tech. Adv. Mem. 98-08-002 (Feb. 20, 1998). Likewise, a blood donor with sufficient proof of profit motive and regular activity was held to be in the trade or business of donating blood. *Green v. Commissioner*, 74 T.C. 1229 (1980). Most blood donors, of course, lack either a profit motive or the regularity required to claim that donations are part of the donor’s trade or business.

<sup>124</sup> And similarly, an activity that starts as a trade or business may become a hobby or some other nonbusiness activity. See, e.g., *Kartrude v. Commissioner*, 56 T.C.M. 500 (1988), *rev’d in part on other grounds*, 925 F.2d 1379 (11th Cir. 1991).

are the primary readers of tax legislation, and they are, then it makes sense sometimes for Congress to use the jargon that is largely understood by the primary audience.<sup>125</sup>

The proper place for reader-friendly text with diagrams and examples is the publications and instructions published by the Service. These materials, intended for ordinary taxpayers as well as tax professionals, offer helpful interpretations of the Code and Treasury Regulations.<sup>126</sup> Since they contain flowcharts, worksheets, and examples, they are quite lengthy.<sup>127</sup> Still, these materials provide the untrained expert with access to the tax laws. Some might argue that a simpler Code would eliminate the need for Service publications and instructions, thus saving resources. The Service is better-equipped to provide helpful explanations than Congress. Although Congress should be as clear as possible in its legislation, structural pressures force Congress to write legislation for the trained professional and not for the lay reader. These pressures include the frequent need to enact legislation promptly and the constant need to devote attention to areas other than taxation. Simply put, members of Congress lack the time to carefully re-draft legislation into reader-friendly prose. Of course, members of Congress rely upon their staff members to draft legislation, but the job of informing taxpayers about the effects of legislative change belongs to the executive branch and not the legislative branch.<sup>128</sup>

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<sup>125</sup> Professor Miller observes that the limitation of the general deduction for business expenses in section 162(a) only to those that are “ordinary and necessary” is similarly indeterminate, although tax professionals can sense the contours of this term based on its application in prior cases and rulings. Miller, *supra* note 76, at 35-37.

<sup>126</sup> The Service has prepared a helpful packet for individual and corporate taxpayers that explains the many rules related to deductions for business expenses. INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 535[:] BUSINESS EXPENSES (2002) [hereinafter PUBLICATION 535]. In addition, the Service has published six other general guides, seven guides for employers, and twenty-five specialized guides for various types of business activities, including farming, commercial fishing, and foreign business entities. *Id.* at 58. The total number of Service publications and notices available to taxpayers in 2003 stood at 340 as of January 15, 2003. See Internal Revenue Service, Department of the Treasury, Forms and Publications, at <http://www.irs.gov/formspubs/lists/0,,id=97819,00.html> (last visited Jan. 15, 2003).

<sup>127</sup> PUBLICATION 535, *supra* note 126, for example, is sixty-two pages in length. But that is not the longest Service publication: the tax guide for farmers consumes 127 pages. See INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, PUBLICATION 225[:] FARMER’S TAX GUIDE (2002).

<sup>128</sup> Surrey, *supra* note 23, at 703-710.

If Congress were to draft tax legislation in a manner accessible to the general populace, like Australia's new tax code,<sup>129</sup> Congress would have to write more text, not less. This would be a problem, for although the Code contains sentences that would make a high school English teacher blush,<sup>130</sup> it is also true that the Code generally makes good use of word economy.<sup>131</sup> Word economy itself is good because a reader knows that every word has meaning. In virtually every case, one could not draft a more succinct statement of the rule without changing the substance of the rule.<sup>132</sup> Of course, one could draft clearer statements of the rule if one is willing to lengthen the Code. Remember, however, that proponents of simplification point to the fact that the Code is already approaching 1.4 million words.<sup>133</sup> If length breeds complexity, then more elaborate statements of the law in the Code will not help the cause. Further, if every word has meaning, then adding more words necessarily adds more meanings, which can cause further ambiguity and complication.

The Code is not readily accessible to the average taxpayer, but that conclusion sounds much worse than it is. Even if Congress could create an efficient and equitable Code that would be within the easy grasp of most taxpayers, there is little to suggest that the average taxpayer would read it. Congress knows that tax professionals are the

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<sup>129</sup> Australia recently completed a significant overhaul of its tax laws with the enactment of the "Income Tax Assessment Act" in 1997. One of the principal objectives of this reform effort was to make the tax laws more accessible to taxpayers. To achieve this, the new Australian tax laws replace references to "the taxpayer" with "you." The statute also includes diagrams, extensive purposive statements at the beginning of major sections, and several examples. Critics charge that these efforts to convert technical tax laws into the statutory equivalent of a Denny's menu have produced text that is condescending and unavoidably different than what was in place before reform. See 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 115 (Joint Comm. Print 2001); see also Donald R. DeGlopper, *Australia*, in *id.* app. D at D-183.

<sup>130</sup> The classic example of a sentence gone awry is section 341(e)(1), a single sentence containing 342 words and five parenthetical comments (and, strangely, no footnotes).

<sup>131</sup> See generally Michael A. Livingston, *Congress, the Courts, and the Code: Legislative History and the Interpretation of Tax Statutes*, 69 TEX. L. REV. 819, 827-28 (1991).

<sup>132</sup> As explained already, the Code makes use of technical jargon in order to keep the statement of the rules brief. See *supra* notes 119-125 and accompanying text. This facilitates word economy.

<sup>133</sup> See *supra* note 7.



primary readers of tax legislation, and Congress has too many other concerns to devote excessive resources into re-wording the laws. For these reasons, tax legislation should and will always be technical.

## 2. Temporary Rules

Both the Code and the Treasury regulations contain a number of temporary rules that will either expire on a specified date stated in the rule<sup>134</sup> or by general operation of law.<sup>135</sup> In some cases, Congress or Treasury simply extends the expiration date. Other times, expired provisions remain in the Code or regulations as deadwood. According to the Joint Committee Report, temporary rules contribute to tax complexity because taxpayers must decide whether a provision is still in effect and, if so, whether it will apply to a transaction that may extend beyond the stated expiration date.<sup>136</sup> There are two problems with this argument. First, the Joint Committee Report offers no empirical evidence of increased errors or lost resources attributable to temporary rules. Second, and more important, it ignores the fact that all federal tax rules are temporary. Congress can always add to, subtract from, or otherwise alter the provisions of the Code. In that sense, rules with fixed expiration dates are nothing special. Clearly, Congress should remove deadwood provisions from the Code and regulations, for professional publishing services can preserve their only value – historic reference – by transferring them from the Code and regulations to other volumes accessible to scholars. Yet the elimination of deadwood does not solve the problem of the supposed complexity brought on by

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<sup>134</sup> Code provisions expiring in the years 2002-2010 are set forth in JOINT COMM. ON TAXATION, 108TH CONG., LIST OF EXPIRING FEDERAL TAX PROVISIONS 2002-2010 (Joint Comm. Print 2003). For example, so-called “Archer medical savings accounts,” authorized and described in section 220, will expire on December 31, 2003, unless earlier extended or made permanent by Congress. JOINT COMM. ON TAXATION, 108TH CONG., LIST OF EXPIRING FEDERAL TAX PROVISIONS 2002-2010, at 4. In sum, fifty-seven Code provisions are set to expire in the years 2002 through 2010. *Id.*

<sup>135</sup> All of the revisions to the Code set forth in the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, are set to expire on December 31, 2010, because of budget reconciliation rules. See *infra* Part II.B.4. In that sense, the entire 2001 Act is “temporary.”

<sup>136</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 63 (Joint Comm. Print 2001).

temporary rules. Even if temporary rules do complicate the Code, there is no suggestion for reform except for the elimination of deadwood provisions.<sup>137</sup> Thus, the complexity attributable to temporary rules is either insignificant or unsolvable.

### 3. Congressional Delegation of Authority

One person's convenience is another person's inconvenience. This cliché certainly applies to the Code. When Congress creates a new tax law, it often assigns to Treasury the task of creating additional rules to enforce the new law. By expressly delegating authority to Treasury, the resulting regulations receive the same deference as if Congress had written them directly into the legislation. This method of legislative drafting is efficient for Congress,<sup>138</sup> but it is an added burden for Treasury and an inconvenience for taxpayers.<sup>139</sup> For one thing, taxpayers must wait several months (sometimes years) for Treasury to promulgate the regulations in proposed form.<sup>140</sup> Then, taxpayers must look not only at the statute but also at the regulations for a definitive rule. At a minimum, the cross-referencing burden wastes time. More importantly, though, is the risk that a legislative regulation might either conflict with the statute or be hard to reconcile with the statute. There is nothing to suggest that Congress would seriously consider curtailing its delegation of authority to

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<sup>137</sup> The Joint Committee Report advocates repeal of more than 100 deadwood provisions in the Code. 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 579-93.

<sup>138</sup> Indeed, Congress has flexed this muscle on several occasions. Since 1991, Congress has specifically granted regulatory authority over some aspect of the tax laws on no less than 237 occasions, and this figure does not include authority for studies, inflation adjustments, and form development. Memorandum from Marrie B. Morris, Congressional Research Service, to the Joint Committee on Taxation, Re: Frequency of Grants of Regulatory Authority to Internal Revenue Service in Past Ten Years (Feb. 5, 2001), in 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, app. D at D-94 to D-129.

<sup>139</sup> For more complaints of the complexity of regulations, see Martin J. McMahon, Jr., *Reflections on the Regulations Process: 'Do the Regs Have to Be Complex' or 'Is Hyperlexis the Manna of the Tax Bar?'*, 51 TAX NOTES 1441 (June 17, 1991); Miller, *supra* note 76, at 8.

<sup>140</sup> See Thomas F. Field et al., *The Guidance Deficit[?] A Statistical Study*, 69 TAX NOTES 1023 (Nov. 20, 1995).

Treasury so the added complexity from Congressional delegation is inevitable. Fortunately, Congressional delegation is also desirable. Again, Treasury has greater expertise in the details of tax administration and tax policy than Congress does.<sup>141</sup> Congress should defer to this expertise regularly to ensure better coordination of the tax laws. Since Treasury must explain the laws to taxpayers and enforce those laws, it is sensible to confer limited rulemaking powers on Treasury, even though it burdens tax advisers with added cross-references and there is risk of conflict with Congressional expression or intent.

#### 4. Budget Reconciliation

Any significant change to the Code will impact the amount of revenues derived from the tax. In order to comply with balanced budget rules, Congress cannot simply create, extend, or broaden a tax benefit without finding some way to offset the resulting revenue loss.<sup>142</sup> Consequently, in order to change one rule, Congress must often change other rules to compensate for the first rule change.<sup>143</sup> This necessity to offset contributes to tax complexity.<sup>144</sup>

Compliance with budget reconciliation rules resulted in significant tax complexity with respect to the 2001 Act. It provides that all amendments to the Code made by the 2001 Act shall terminate on December 31, 2010.<sup>145</sup> At that time, the Code applies as if the 2001 Act were never enacted.<sup>146</sup> Congress added the “sunset” provision to avoid triggering section 313 of the Congressional Budget

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<sup>141</sup> See *supra* Part II.B.1.

<sup>142</sup> For an excellent summary of the budget reconciliation rules, see Cheryl D. Block, *Pathologies at the Intersection of the Budget and Tax Legislative Process*, 43 B.C. L. REV. 863 (2002).

<sup>143</sup> In times of revenue surplus, Congress can extend tax benefits without the need to find additional, offsetting revenues. Of course, surplus can only be drained for so long, so Congress must either cause the tax benefit to expire or find offsetting revenue sources prior to depletion of the surplus. If Congress opts to terminate the tax benefit, the complexity of temporary rules, discussed *supra* Part II.B.2., is enhanced. If Congress ultimately decides to generate offsetting revenues, the complexity from budget reconciliation remains.

<sup>144</sup> Professor Block contends that “the budget rules are even more complex than the Tax Code.” Block, *supra* note 142, at 871.

<sup>145</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 901, 115 Stat. 38, 150.

<sup>146</sup> *Id.*

Act of 1974,<sup>147</sup> the so-called “Byrd rule.”<sup>148</sup> The Byrd rule permits a Senator to raise a point of order against “extraneous” provisions contained in a reconciliation bill. If the presiding officer sustains the point of order,<sup>149</sup> the extraneous provision disappears unless three-fifths of the Senate membership (sixty votes, assuming no vacant seats) vote to waive the rule with respect to that provision. Any provision that would increase or decrease revenues in a year beyond those covered by the reconciliation measure is an “extraneous” measure.<sup>150</sup> Consequently, all of the provisions in the 2001 Act had to expire at the end of the reconciliation period, ten years, or else they would be subject to a “point of order” on the Senate floor. Some aspects of the 2001 Act appeared to lack the sixty votes required to save a provision from the Byrd rule so the Senate added a comprehensive sunset rule to protect the final legislation from procedural challenge.

This preemptive strike against the Byrd rule leaves taxpayers with a new set of laws that will lose all force approximately ten years after enactment unless Congress extends the sunset date or makes the 2001 Act changes permanent. Thus, planning decisions become more difficult, especially for taxpayers making long-range decisions like estate planning. The 2001 Act causes the gradual repeal of the federal estate tax and the federal generation-skipping transfer tax.<sup>151</sup> Final repeal occurs at the end of 2009,<sup>152</sup> but then the repeal expires with respect to decedents dying after December 31, 2010.<sup>153</sup> Assuming no modification or extension of the 2001 Act in the interim, then,

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<sup>147</sup> Congressional Budget Act of 1974, 93 Pub. L. No. 344, § 313, 88 Stat. 297, amended by Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 13214, 104 Stat. 1388 (codified at 2 U.S.C. § 644 (2001)).

<sup>148</sup> The principal sponsor of the permanent extension of section 313 was Senator Robert C. Byrd of Virginia.

<sup>149</sup> Any Senator can appeal the ruling of the presiding officer, and if the appeal is successful, the ruling is overturned.

<sup>150</sup> 2 U.S.C. § 644(b)(1) (2001). Other types of “extraneous” provisions are those that: (1) do not affect outlays or revenues, (2) violate the instructions assigned to the sponsoring committee, (3) violate the jurisdiction of the sponsoring committee, (4) produce revenue changes that are “merely incidental” to the nonbudgetary aspects of the provision, and (5) recommend changes to Social Security. *Id.*

<sup>151</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 501(a), 115 Stat. 38, 69. The 2001 Act retains a modified form of the federal gift tax beginning in 2010. *Id.* at § 511, 115 Stat. 38, 70.

<sup>152</sup> I.R.C. § 2210(a).

<sup>153</sup> Economic Growth and Tax Relief Reconciliation Act of 2001 § 901, 115 Stat. at 150.

estate tax repeal will last for only one year. As the year of repeal is far off, one can jokingly dismiss this possible result as legislation that will encourage massive patricide in 2010. Yet, in all seriousness, individuals with taxable estates<sup>154</sup> must plan for a number of contingencies in the short term: death before repeal, death during repeal, and death after repeal. Each of these contingencies might produce different estate plans, significantly complicating the estate planning burdens of the wealthiest taxpayers.

Even less affluent taxpayers face more complicated planning decisions because of the 2001 Act's tentative sunset, though these decisions will not occur until the years just before the sunset. The 2001 Act expands the scope of the deduction for interest paid on student loans in two ways: first, it increases the income levels at which the benefit of the deduction is phased out; and second, it eliminates the sixty-month limitation on the period of time for which a deduction is available. As with the rest of the 2001 Act, these provisions expire at the end of 2010. Unless and until Congress makes these rules permanent before the sunset date, taxpayers considering how to finance future higher education expenses should have two alternate plans: one that assumes the continued deductibility of student interest under the new, broader rules; and another that contemplates the effects of returning to prior law.<sup>155</sup>

The complexity resulting from budget reconciliation is clearly not insurmountable.<sup>156</sup> Frankly, the trade-off for this complexity, long-term budget reconciliation, is not as defensible as other trade-offs considered herein. Given the frequency with which the tax laws change, to say nothing of the uncertainty of long-term economic forecasts, it is somewhat silly for Congress to force itself to reconcile revenues for ten full years. Congress is effectively constraining itself

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<sup>154</sup> An estate faces liability for federal estate taxes if the taxable estate (defined under sections 2051 and 2053 as the gross estate less allowable deductions) exceeds what remains of the decedent's "applicable exclusion amount" under section 2010(c). For decedents dying in 2001, the applicable amount, assuming no lifetime taxable gifts, is \$675,000. The exemption grows to \$1 million for 2002 and 2003, then to \$1.5 million in 2004 and 2005, then again to \$2 million in 2006, 2007, and 2008, and finally to \$3.5 million in 2009. I.R.C. § 2010(c).

<sup>155</sup> Arguably, a taxpayer wanting to finance future higher education costs ought to have alternate funding plans even if the 2001 Act rules were not scheduled to sunset. After all, Congress can always change the rules and taxpayers, knowing this, should be prepared in case such changes occur. But the likelihood of change seems much greater when rules have a scheduled expiration date.

<sup>156</sup> See Block, *supra* note 142, for more on the "gimmickry" of budget reconciliation and its impact on federal tax policy.

by longshot estimates of future revenues and expenses. Sound fiscal policy certainly requires some effort at reconciliation, but why not limit the budget horizon to a more reasonable time frame, like three to five years? The response to this query, seemingly, is that it would be politically unfeasible for a subsequent Congress to take away benefits given to taxpayers by a prior Congress. Recent history, however, shows that this is not the case. Both President Clinton and the first President Bush approved tax increases that took away some of the benefits provided to taxpayers by Congress in the 1980s.<sup>157</sup> Ultimately, budget reconciliation is neither inherent nor especially useful. Thus, simplification proposals aimed to eliminate budget reconciliation complexities are justified. Of course, traditional simplification proposals are not concerned with reformation of budget reconciliation rules so this justification for simplification will rarely apply.

### C. Complexity in the Name of Equity

Tax complexity is also a necessary cost to provide an equitable taxing system. Congress has often sacrificed simplicity for the cause of equity, an implicit recognition that fair laws are more desirable than easy laws.

#### 1. Deference to State Laws

The federal tax laws often defer to applicable state laws to determine the interests and rights of taxpayers,<sup>158</sup> especially for federal estate and gift purposes. For example, the decedent's property interests under applicable state law govern the interests included in a decedent's gross estate.<sup>159</sup> A decedent's estate in a

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<sup>157</sup> The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, lowered tax rates and compressed the number of tax brackets. See *supra* note 6.

<sup>158</sup> At least 116 Code sections contain one or more references to state law. See Congressional Research Service, *Tax Simplification Project*, in 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, app. D, at D-151. In most cases, according to the Congressional Research Service, these references have little measurable effect on tax complexity. *Id.*

<sup>159</sup> I.R.C. § 2033; *Morgan v. Commissioner*, 309 U.S. 78, 82 (1940); see also *Commissioner v. Estate of Bosch*, 387 U.S. 456, 465 (1967) (Federal courts should follow decisions of State's highest court with respect to property rights and should give "proper regard" to decisions of lower State courts).

community property state, for example, will include only one-half of the value of all community property since under state law the decedent owned (and can only transfer at death) an undivided one-half interest in the community property.<sup>160</sup>

Deference to community property laws is also present in the federal income tax. In a community property state, the law deems each spouse to earn one-half of the community income. As a result, spouses in community property states paid less total tax because each spouse made use of the lower tax brackets.<sup>161</sup> The deference to community property laws thus created inequity between spouses in community property states and those in separate property states. Rather than accept the inequity for the sake of simplicity, however, Congress responded by creating the joint return,<sup>162</sup> where spouses in separate property states could also pool income and obtain a tax benefit similar to spouses in community property states.<sup>163</sup> Since both spouses sign the return,<sup>164</sup> the joint return then caused the need for relief provisions for innocent spouses.<sup>165</sup> Both the joint return and the innocent spouse relief rules contribute to the Code's complexity. In many cases, the Code contains separate rules for taxpayers filing a joint return. To name but a few examples, taxpayers filing a joint return use different tax tables, have a different standard deduction, and are entitled to double the maximum exclusion from gain on the

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<sup>160</sup> RICHARD B. STEPHENS ET AL., FEDERAL ESTATE & GIFT TAXATION ¶ 4.05[5][a] (8th ed. 2002).

<sup>161</sup> To illustrate, suppose that a married couple living in New York (a separate property state) earned \$100,000 and that all of this income was earned by one spouse. Until 1948, each spouse filed a separate return, so the earning spouse would report and pay tax on the \$100,000. The non-earning spouse would have no income and pay no tax. A similar couple living in Texas (a community property state), however, would have a different result. Each spouse in the Texas couple would report and pay tax on \$50,000 of income. See *Poe v. Seaborn*, 282 U.S. 101 (1930). Because of progressivity, the total tax paid by two persons with income of \$50,000 is less than the total tax paid by one person with \$100,000 of income.

<sup>162</sup> I.R.C. § 6013(a).

<sup>163</sup> Since the tax brackets for married couples filing a joint return are not double those for unmarried taxpayers, though, the joint return was generally a worse result for residents of community property states. To obtain overall equity, therefore, spouses in community property states were forced to relinquish some of their benefit in order to share the overall benefit of pooled income with spouses in separate property states.

<sup>164</sup> I.R.C. § 6013(d)(3) makes both spouses jointly and severally liable for any deficiencies assessed on a joint return.

<sup>165</sup> I.R.C. § 6015.

sale of a principal residence.<sup>166</sup> Moreover, the innocent spouse relief rules, while recently overhauled,<sup>167</sup> continue to add to tax complexity.<sup>168</sup>

The Code is not entirely deferential to state law, and such inconsistent deference to state law also has been cited as a cause of

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<sup>166</sup> See I.R.C. §§ 1(a) (statutory tax table for married couples filing joint returns), 63(c) (standard deduction), 121(b)(2)(A) (\$500,000 exclusion for joint return filers meeting certain additional requirements). It borders on understatement to note that many of these differences are controversial. So-called “marriage penalties” (and the often overlooked “marriage bonuses”) are collateral effects of the different deduction amounts and rate tables applicable to taxpayers filing joint returns. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38, Congress purports to mitigate marriage penalties in several Code provisions. See, e.g., I.R.C. §§ 1(f)(8) (marriage penalty relief for income tax tables beginning in 2005), 63(c)(7) (relief for standard deduction amounts, also beginning in 2005). For more on marriage penalties and marriage bonuses generally, see Larry Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339 (1994).

<sup>167</sup> See I.R.C. § 6015 (originally enacted as Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, § 3201(a), 112 Stat. 685, 734). Section 6015 applies to joint and several liability on a joint return outstanding on (or arising after) July 22, 1998. Under section 6015, an innocent spouse can claim relief from joint and several liability using any of three separate methods. First, an innocent spouse is entitled to relief if he or she can establish that: (1) a joint return was filed; (2) an understatement of tax is attributable to an error of the other spouse; (3) in signing the return, the innocent spouse had no knowledge or reason to know of the understatement; and (4) it is inequitable to hold the innocent spouse accountable under the facts and circumstances. I.R.C. § 6015(b). Second, if the innocent spouse can prove how the deficiency should be allocated between the spouses, each spouse will be held liable only for that portion allocable to him or her. I.R.C. § 6015(c). This apportionment scheme is available only where the spouses are divorced or legally separated and, even then, only if the spouses did not share the same household for the twelve months prior to the date when the innocent spouse filed for relief. *Id.* Finally, if relief under the first two avenues is not available, the innocent spouse can argue for “equitable relief” under section 6015(f).

<sup>168</sup> See, e.g., Kari Smoker, *Internal Revenue Service Restructuring and Reform Act of 1998: Expanded Relief for Innocent Spouses – At What Cost? A Feminist Perspective*, 60 OHIO ST. L.J. 2045 (1999); Jessica Luby Angney, Note, *It's New But Is It Improved?: The New “Innocent Spouse” Provision*, 47 CLEV. ST. L. REV. 603 (1999). Courts are also grappling with the new law. See, e.g., *Grossman v. Commissioner*, 182 F.3d 275 (4th Cir. 1999); *Mlay v. Internal Revenue Service*, 168 F. Supp. 2d 781 (S.D. Ohio 2001); *In re Hinckley*, 256 B.R. 814 (Bankr. M.D. Fla. 2000); *Alt v. Commissioner*, 119 T.C. 306 (2002); *Maier v. Commissioner*, 119 T.C. 267 (2002); *Jonson v. Commissioner*, 118 T.C. 106 (2002); *Mueller v. Commissioner*, 82 T.C.M. (CCH) 190 (2001); *Vetrano v. Commissioner*, 116 T.C. 272 (2001); *King v. Commissioner*, 116 T.C. 198 (2001); *Miller v. Commissioner*, 115 T.C. 582 (2000); *Cheshire v. Commissioner*, 115 T.C. 183 (2000); *Corson v. Commissioner*, 114 T.C. 354 (2000); *Butler v. Commissioner*, 114 T.C. 276 (2000).



complexity.<sup>169</sup> For instance, federal tax liens can attach only to interests in property defined under state law, but state law homestead exemptions are generally disregarded for this purpose.<sup>170</sup> The deference federal tax laws give to state laws should vary, even if it forces taxpayers and their advisers to perform more research. A rule of blanket deference to state laws would be challenged on equity grounds. Eventually, as with the joint return, Congress would create inconsistencies to address the problems, quickly returning to the status quo. At the other extreme, wholesale disregard of state laws would present different equity concerns and would force Congress, now unable to cross-reference state laws for convenience, to write even more detailed legislation. The inconsistent application of state law is not only inevitable but is the most equitable rule to apply. The increased complexity that results is acceptable.

## 2. Applicability of Foreign Laws

U.S. taxpayers with activities in other countries must deal with multiple tax regimes, an inherent complexity that U.S.-based reform can only alleviate to some extent. While the Code makes several references to foreign laws,<sup>171</sup> those references do not create much complexity.<sup>172</sup> Instead, complexity stems from the various income tax treaties between the United States and other countries.<sup>173</sup> The federal government has made some effort to simplify tax treaties by promulgating a model income tax treaty<sup>174</sup> that the United States uses

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<sup>169</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 75-87 (Joint Comm. Print 2001).

<sup>170</sup> *Herndon v. United States*, 501 F.2d 1219 (8th Cir. 1974).

<sup>171</sup> The Internal Revenue Code contains 123 references to laws of other countries. Congressional Research Service, *Complexity Attributable to Statutory References in the Internal Revenue Code to Foreign Laws or Attributable Generally to Treaties with Foreign Countries*, in 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, app. D, at D-164.

<sup>172</sup> *See id.*

<sup>173</sup> *See id.* at D-172.

<sup>174</sup> Department of the Treasury, United States Model Income Tax Convention of September 20, 1996, available at <http://www.treas.gov/offices/tax-policy/treaties.html> (last visited Jan. 15, 2003).

as a discussion draft.<sup>175</sup> Of course, the final treaties are a product of negotiation, and no two treaties will be identical for this reason. The added complexity of tax treaties burdens taxpayers engaged in business activities outside the United States, but in many cases those same taxpayers receive benefits under the treaties.<sup>176</sup> Taxpayers with income activities in more than one country outside the United States also face multiple tax treaties, but generally speaking these taxpayers can afford the additional burdens imposed by multiple treaties.<sup>177</sup> Again, to the extent that tax treaties operate to benefit taxpayers by mitigating instances of double taxation, taxpayers should easily tolerate the complexity resulting from the application of foreign laws.<sup>178</sup>

### 3. Absolute and Relative Rules

The Code makes liberal use of both situational rules and absolute rules, and the combination of the two increases complexity.<sup>179</sup> Situational rules are those that require a factual determination before the rule can be applied. For example, the Code requires a shareholder to recognize gain on the transfer of encumbered property to a corporation if the transfer is principally motivated by tax avoidance.<sup>180</sup> In order to apply this rule, the taxpayer must first make

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<sup>175</sup> For detailed information on the income tax treaty negotiation process, see 2 PHILIP F. POSTLEWATE & SAMUEL A. DONALDSON, *INTERNATIONAL TAXATION: CORPORATE AND INDIVIDUAL* §§ 13.01-13.03 (4th ed. 2003).

<sup>176</sup> Income tax treaties often confer relief from potential double taxation by the United States and one or more other countries, and they often provide for reduced tax rates on business or investment income. See BORIS I. BITTKER & LAWRENCE LOKKEN, *FUNDAMENTALS OF INTERNATIONAL TAXATION* ¶ 66.3, at 66-35 (2001).

<sup>177</sup> See, e.g., Bruce Anderson, *Strategic Choice Taxation: A Solution to the Federal Revenue Crisis*, 1995 COLUM. BUS. L. REV. 281, 331 (1995); Pollack, *supra* note 4, at 356.

<sup>178</sup> With respect to U.S. taxation of foreign persons and of foreign-source income, however, many commentators have bemoaned the complexity of the Code and regulations. See, e.g., CHARLES H. GUSTAFSON ET AL., *TAXATION OF INTERNATIONAL TRANSACTIONS* 24-25 (2d. ed. 2001); JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* 8 (2000). In contrast, this part of the article relates to a different matter: how the reliance on foreign laws increases tax complexity. The actual complexity of the Code's subchapter N (international taxation) is beyond the scope of a section devoted to trade-offs in tax complexity and not to a list of those provisions which are complex.

<sup>179</sup> See generally Richard J. Kovach, *Bright Lines, Facts and Circumstances Tests, and Complexity in Federal Taxation*, 46 SYRACUSE L. REV. 1287 (1996).

<sup>180</sup> I.R.C. § 357(b).

the determination that the transfer was so motivated. Another, more common example (though not one written into the Code) involves the exclusion from gross income for gifts received from another.<sup>181</sup> The Supreme Court accidentally defined a “gift” as a transfer made on account of “detached and disinterested generosity,” an action made from “affection, respect, admiration, charity or like impulses.”<sup>182</sup> Again, application of the Court’s rule depends upon the unique circumstances giving rise to the transfer.<sup>183</sup>

Absolute rules, by contrast, make broad conclusions that require no factual determination and seemingly leave no room for exception. For example, an individual taxpayer may claim a child age twenty-four or over as a “dependent” on the taxpayer’s federal income tax return – and thus claim a dependency exemption attributable to the dependent – only if the child’s gross income is less than the claimed exemption amount *and* if the taxpayer provides more than half of the child’s total support.<sup>184</sup> If the child has gross income in an amount that equals or exceeds (even by only one dollar) the exemption amount, there is no dependency exemption even where the taxpayer furnishes all of the child’s support on top of the child’s gross income. Absolute rules are defensible on the grounds of administrative convenience. They also allow for more certainty in planning and, if unchallenged, reduce the amount of disputes between taxpayers and the Service.

Herein lies the problem. Since the Code makes extensive use of both situational and absolute rules, the effectiveness of both types of rules becomes hampered.<sup>185</sup> Taxpayers are more apt to challenge absolute rules when the Code contains other situational rules than when it does not. After all, they might suppose, if Congress or the

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<sup>181</sup> I.R.C. § 102(a).

<sup>182</sup> *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960). It is proper to term the Court’s test as an “accidental” one because the Court specifically stated that it wanted to avoid announcing a test because of the fact-intensive nature of the gift inquiry. *Id.* at 284-85.

<sup>183</sup> *See, e.g., Goodwin v. United States*, 67 F.3d 149 (8th Cir. 1995), *aff’g* 870 F.Supp. 265 (S.D. Iowa 1994) (special occasion donations to pastor from congregation were compensation, not gifts, because such donations were paid from the congregation as a whole and were routinely paid according to a fixed method); *Runyon v. Commissioner*, 49 T.C.M. (CCH) 208 (1984) (payments to taxpayer from shareholders of corporation for which taxpayer performed services were excludable as gifts because taxpayer was fully compensated for services by the corporation and shareholders expected nothing more in exchange for their payments).

<sup>184</sup> I.R.C. § 151(c)(1).

<sup>185</sup> *See Kovach, supra* note 179, at 1300-06.

courts are willing to consider the factual circumstances in applying one rule, they will also consider the circumstances in applying other rules. Likewise, taxpayers fighting against the application of a situational rule are more apt to argue that an absolute rule should resolve the inherent uncertainty of a situational rule.<sup>186</sup> Simply put, if the Code contained exclusively situational rules, no one would waste time arguing that the rule is uncertain. Likewise, if the Code contained only absolute rules, no one would bother arguing for exceptions based on the unique circumstances. Either extreme might further simplicity.

Yet no one wants a Code that consists solely of situational rules. Taxpayers are willing to lose on some minor points in favor of some absolute rules that offer some degree of certainty. When the absolute rules are grossly unfair, the taxpayer can fight for change, either in the courts or through the legislative process. If the rules are only slightly unfair, the taxpayer may be willing to let the inequity slide, knowing that other absolute rules may favor the taxpayer without having to make a factual showing to obtain the claimed benefit. The other extreme – a Code filled with only absolute rules – is equally unappealing. Only taxpayers grossly harmed by the resulting inequities (or those with sufficient resources and desire to challenge less harmful inequities) will have sufficient interest to challenge the absolute rules.<sup>187</sup> If taxpayers respect the absolute rules, they must consistently lose regardless of where the equities may lie. Here again we must prefer the inevitable complexity, this time because complexity stems from having both situational and absolute rules, the preferred result.

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<sup>186</sup> On occasion, the Service accommodates this request. For example, section 305(b)(2) states that a stock dividend is taxable to the recipient shareholders if, in the same or a related distribution, other shareholders receive cash or other property. The determination of whether any two distributions are “related” involves application of a situational rule. In the regulations, Treasury relented to taxpayer requests for guidance, providing a presumption that any two distributions within thirty-six months will be presumed “related” absent additional evidence. Treas. Reg. § 1.305-3(b)(4) (1995). Treasury’s presumption is an example of an absolute rule used to clarify a situational rule.

<sup>187</sup> Professor Miller notes the geographic constraint on moving expenses is “patently unfair,” and argues that excessive use of bright-line rules undermines the legitimacy of the tax law. Miller, *supra* note 76, at 43-44.

#### 4. Special Treatment of Certain Taxpayers

Public utilities,<sup>188</sup> life insurance companies,<sup>189</sup> and other taxpayers subject to federal and/or state regulation<sup>190</sup> often receive special tax treatment, usually because compliance with other federal and/or state regulations forces these taxpayers to act differently than otherwise similarly-situated taxpayers. Likewise, taxpayers involved in farming,<sup>191</sup> the oil and gas industry,<sup>192</sup> the timber industry,<sup>193</sup> or other special business activities also receive preferential treatment through

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<sup>188</sup> Regulated public utilities, as defined in section 7701(a)(33), are subject to many special rules. For example, a regulated public utility may, in general, use the accelerated cost recovery deductions applicable to other taxpayers if the utility also applies a “normalization method of accounting,” whereby accounts for tax, book, and ratemaking purposes are harmonized by having the utility create a reserve for deferred federal income taxes when tax depreciation exceeds book depreciation. See I.R.C. § 168(f)(2), (i)(9)–(10); see also 4 STANDARD FEDERAL TAX REPORTER (CCH) ¶ 11,070.031 (2001). Regulated public utilities also have special rules for the capitalization of unclassified labor costs. See Internal Revenue Service, *Coordinated Issue[.] Utilities Industry[.] Capitalization of Costs – Unclassified Labor Costs*, at <http://www.irs.gov/pub/irs-isp/ut-263ar.pdf> (Sept. 30, 1998); see also I.R.C. § 247(a) (special deduction for dividends paid on certain preferred stock issued prior to October 1, 1942); Treas. Reg. § 1.244-1 (1960) (special dividends-received deduction for corporations receiving dividends on such preferred stock from a public utility).

<sup>189</sup> See I.R.C. §§ 801-848 (special rules for taxation of life insurance companies).

<sup>190</sup> See, e.g., I.R.C. §§ 581-587 (special rules for banking institutions); 851-855 (special rules for regulated investment companies).

<sup>191</sup> See, e.g., I.R.C. §§ 77 (special elections with respect to loans from the Department of Agriculture’s Commodity Credit Corporation), 126(a) (exclusion of certain cost-sharing payments received under state and federal programs), 175 (deduction of soil and water conservation expenditures), 451(d) (election to defer income from crop insurance and federal disaster payments until next year if damaged crops would have sold that year), 453(l)(2)(A) (special exception from limitation on use of installment method for dealers), 464 (limited use of cash method for prepaid feed, seed, fertilizer, and similar farm supplies).

<sup>192</sup> See, e.g., I.R.C. §§ 43 (credit for 15% of taxpayer’s enhanced oil recovery costs), 59(e) (exemption from alternative minimum tax treatment of certain deductions if taxpayer elects to amortize said deductions ratably over periods up to ten years), 611–613A (depletion deduction), 616 (deduction for development of mine or other mineral deposit), 617 (deduction for mining exploration costs with subsequent recapture upon reaching production stages).

<sup>193</sup> See, e.g., I.R.C. §§ 48(b) (10% regular investment tax credit on reforestation costs), 194 (election to amortize up to \$10,000 of reforestation expenditures over eighty-four months), 611 (depletion deduction), 631(a) (election to treat cutting of timber as hypothetical sale or exchange eligible for preferential tax treatment equal to that received for sale of standing timber), 1231(b)(2) (timber gains and losses eligible for special characterization under section 1231(a)).

special rules, exceptions, and exemptions. In these cases, Congress determined that application of the general rules to these taxpayers would either give them incentives to engage in inefficient behaviors or, in some cases, force them out of the business activity entirely. Preferential rules for specific groups of taxpayers obviously complicate the Code because taxpayers must determine whether they are eligible for the preferential rule and, if so, exactly what benefit they can obtain under the special rule. In many cases, professionals devoted to one industry can charge high fees to provide advice to taxpayers in that industry – a cost borne by the very taxpayers Congress hoped to benefit. Complaints from taxpayers within the special industries rarely cry for simpler rules – what they usually seek are broader rules with easier eligibility requirements. Apparently, as long as special rules confer benefits, their complexity is not a significant problem.

Even if the target beneficiaries of a preferential rule are satisfied, the Code is still more complicated as a result of these special rules.<sup>194</sup> These special rules are certainly not inevitable, at least in theory – Congress could restrain itself or write general rules that do not need special exceptions. The former suggestion, Congressional restraint, is simply a hallucination, for elected officials will always seek to provide special benefits for their constituents.<sup>195</sup> The latter suggestion, drafting legislation that eliminates the need for special exceptions, might cost too much revenue. For example, the Code could extend the special use valuation rules for farmers<sup>196</sup> to all estates, but if the Service measures all real property by actual use and not its highest and best use, as required by current law,<sup>197</sup> Congress loses revenue and encourages inefficient behavior. A special exception for farmers is acceptable to make sure that most farmland remains as such.

The final query is whether taxpayers actually use the special rules. If not, Congress should revise or eliminate the preference. For example, if only a few taxpayers make use of the estate tax deduction for “qualified family-owned business interests,”<sup>198</sup> either there are too

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<sup>194</sup> See McCaffery, *supra* note 5, at 1284-85.

<sup>195</sup> *Id.* at 1301; see also Doernberg & McChesney, *supra* note 60.

<sup>196</sup> I.R.C. § 2032A. For more on so-called “special use valuation,” see STEPHENS ET AL., *supra* note 160, at ¶ 4.04.

<sup>197</sup> Treas. Reg. § 20.2032A-3(a) (1981). See also STEPHENS ET AL., *supra* note 160, at ¶ 4.02[3][b].

<sup>198</sup> I.R.C. § 2057. This deduction is scheduled to terminate with respect to decedents dying after December 31, 2003. I.R.C. § 2057(j). The scheduled termination is likely a result of the scheduled increase in the “applicable exclusion

few taxpayers in the class, the requirements are too tough, or the special rule is not desired by those affected.

### III. THE ALLEGED HARMS OF TAX COMPLEXITY

So with the limited exception of budget reconciliation, all of the components of tax complexity are either inherent, non-unique, or net beneficial. A complex system is not necessarily a bad one. Simplification proponents routinely cite five disadvantages of tax complexity: (1) it undermines taxpayer faith in the system; (2) it jeopardizes the integrity of the voluntary assessment system; (3) it increases the government's cost in collecting revenues, thus reducing the efficiency of the tax; (4) it increases the compliance burden to taxpayers; and (5) it promotes disputes between taxpayers and the Service. The arguments supporting these alleged drawbacks, however, do not withstand careful scrutiny.

#### *A. Complexity Undermines Faith*

A popular rhetorical argument posits that a complex system breeds distrust by taxpayers. The Joint Committee Report adopts this argument, citing four ways in which complexity fosters perceived unfairness by taxpayers:

First, ambiguity in the tax laws can result in disparate treatment of similarly situated taxpayers and can lead individual taxpayers to believe that they bear a disproportionate tax burden. Second, taxpayers may believe that complexity creates opportunities for manipulation of the tax laws by other taxpayers, and confers an advantage for taxpayers who are willing and able to obtain professional advice on reducing their tax liabilities. Third, taxpayers may become disillusioned with tax policy that appears to be

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amount" in 2004 for all decedents to \$1.5 million, which would exceed the combined \$1.3 million effective exclusion amount available through use of the section 2057 deduction. In other words, the \$1.5 million exclusion amount would make the current deduction for qualified family-owned business interests moot, so Congress decided to terminate the deduction.

Treasury has not issued formal statistics indicating whether a large number of estates eligible to claim the deduction have done so. This is because the deduction has only been in effect since 1997. For a critique of the deduction, see generally Neil E. Harl, *The Family-Owned Business Deduction: Still in Need of Repairs*, 4 DRAKE J. AGRIC. L. 59 (1999).

inconsistent because of the uncertainty that emanates from complex tax laws. In addition to causing inadvertent noncompliance, complex and confusing tax laws can instill cynicism among taxpayers, which ultimately can lead to intentional noncompliance.<sup>199</sup>

Dealing with these points in order, assume for a moment that ambiguous tax laws do indeed cause disparate treatment among similarly situated taxpayers. There is nothing to link ambiguity to tax complexity. As previously discussed,<sup>200</sup> complex laws are not necessarily ambiguous. Indeed, one of the greatest complexities in taxation is the need to comb through highly-detailed regulations. These voluminous regulations, while immensely difficult, are hardly ambiguous. Likewise, simple laws are not unambiguous. In fact, simple laws are probably more ambiguous than complex ones.<sup>201</sup> Even if complex laws are more ambiguous, the Joint Committee Report offers no examples of a situation where ambiguity caused the unintentionally disparate treatment of similarly situated taxpayers. If such a case ever occurs, taxpayers can turn to the legislative or judicial branches of government for a remedy. If the disparate treatment is indeed unintentional, those branches are equipped to cure the inequity. The Joint Committee Report offers no reason for questioning the relief provided by these other branches. If the disparate treatment is intentional, however, the disadvantaged taxpayer can either accept the result or advocate reform.

As for the argument that complexity invites manipulation, we have already seen that taxpayers have incentives to find and exploit loopholes whether the tax rules are simple or complex.<sup>202</sup> Other taxpayers will envy any taxpayer with the ability to hire professionals to exploit the rules as much as possible, which would occur even under a "simpler" tax regime. Further, the Joint Committee Report offers no indication of the impact of taxpayer jealousy. Apparently, it has no effect on taxpayer compliance.<sup>203</sup> Absent some indication of the problem with taxpayer jealousy, it is enough to note its inevitable

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<sup>199</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 109 (Joint Comm. Print 2001).

<sup>200</sup> See *supra* Part II.A.4.

<sup>201</sup> See *supra* Part II.B.1.

<sup>202</sup> See *supra* Part II.A.7.

<sup>203</sup> See *infra* Part III.B.



existence.<sup>204</sup>

The next argument, that taxpayers become disillusioned when they encounter complex laws that are seemingly contradictory to established tax policy, is simply unfounded. It is idealistic to believe that taxpayers as a whole understand (and care about) each of the core aspects of federal tax policy.<sup>205</sup> They know that the government will withhold a certain percentage from each paycheck and they think that amount is too much.<sup>206</sup> They understand that the withheld amounts are used to pay for federal programs, but they think these programs suffer from extensive mismanagement and waste.<sup>207</sup> If asked, taxpayers might well have informed (at least semi-informed) opinions on some high-profile tax policy issues ranging from the marriage penalty to progressivity to the preference for capital gains.<sup>208</sup> Taxpayers, however, may not easily grasp (or even care about) other basic tenets of tax policy, including capitalization, deductions for personal consumption expenditures, and the like. It is highly doubtful, therefore, that taxpayers are frustrated with inconsistent tax

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<sup>204</sup> Professor McCaffery says the perception that the rich and intelligent are given an edge under a complex tax regime “may well violate welfarist, utilitarian, pragmatic, process-oriented, natural rights-based or virtually any other definition of equity.” McCaffery, *supra* note 5, at 1281. But Professor McCaffery does not explain how this facial inequality translates into an identifiable harm, nor does he necessarily assert that the facial inequality itself is a harm.

<sup>205</sup> There is evidence, however, that taxpayers will alter their behaviors as tax policy decisions are implemented. See, e.g., McCaffery, *supra* note 5, at 1308 n.196 (citing Whittington et al., *Fertility and the Personal Exemption: Implicit Pronatalist Policy in the United States*, 80 AM. ECON. REV. 545 (1990)).

<sup>206</sup> A Gallup survey conducted from April 6 to April 8, 2001, found that 65% of Americans considered their own federal income tax liabilities to be “too high,” while only 31% said their tax liability was “about right.” See The Gallup Poll, *available at* <http://www.pollingreport.com/budget.htm> (last visited Jan. 14, 2003). Only twice before, in 1969 and 1998, have more Americans concluded that their tax liability was too high. In most years, about 60% felt that their tax liabilities were too high. *Id.*

<sup>207</sup> In one survey of 1043 adults conducted by ABCNews.com from April 10 to April 14, 2002, respondents concluded that out of every dollar the federal government collects in taxes, forty-seven cents is wasted. See ABCNews.com Poll, *available at* <http://www.pollingreport.com/budget.htm> (last visited Jan. 14, 2003).

<sup>208</sup> In an Associated Press poll of 1008 adults conducted from March 22 to March 26, 2002, respondents were asked whether they would be willing to give up some deductions to make the tax system simpler. Of the respondents, 36% were so willing, but 53% were not. The remainder consisted of those with no opinion (10%) and those who volunteered that they did not pay taxes (2%). The fact that the reported percentages do not add to 100% is likely due to rounding. See Associated Press Poll, *available at* <http://www.pollingreport.com/budget.htm> (last visited Jan. 14, 2003).

policy.<sup>209</sup> Even if disillusionment was pervasive, there is no measurable harm that results.

The last argument, that complexity breeds cynicism, has merit. That cynicism then breeds intentional noncompliance, however, is an unsupported conjecture. As will be seen,<sup>210</sup> compliance rates have remained steady in the face of increased complexity. Some might argue that the last link in the chain is unnecessary, that it is bad enough that complex laws inspire skepticism among taxpayers. If tax complexity is required to advance other important objectives, widespread skepticism is much more tolerable. Like the minimal harms of taxpayer jealousy and disillusionment, skepticism does not outweigh the benefits of tax complexity. While these minor harms are unattractive, they are acceptable.

### *B. Complexity Jeopardizes the Integrity of Voluntary Assessment*

This argument, a close relative of the previous one, suggests that if taxpayers do not understand a law, compliance with the law is virtually impossible. Taxpayers do not necessarily intend to cheat the system; instead, frustrated taxpayers simply throw up their collective arms at a difficult rule, not even trying to understand its application.<sup>211</sup> Such frustration in turn risks the integrity of the voluntary assessment system.

Voluntary assessment is an important feature of the federal income tax.<sup>212</sup> If there is a perception that voluntary compliance does

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<sup>209</sup> One commentator argues that taxpayers complain more of tax complexity than the amount of taxes they pay. Gale, *supra* note 9, at 1465. But even if this is true, it does not necessarily follow that taxpayers are frustrated with inconsistent policies, as the Joint Committee Report claims. 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 6 (Joint Comm. Print 2001).

<sup>210</sup> See *infra* Part III.B.

<sup>211</sup> See Eugene Carlson, *Tax Compliance by Small Businesses Eroded in the '80s*, WALL ST. J., June 27, 1991, at B2 (quoting former Service Commissioner Fred T. Goldberg, Jr., as stating “most noncompliance is unintentional. Much of it is due to the complexity of the tax laws.”); Gale, *supra* note 9, at 1465; McCaffery, *supra* note 5, at 1290.

<sup>212</sup> *Flora v. United States*, 362 U.S. 145, 176 (1960) (the income tax system is “based upon voluntary assessment”); *Couch v. United States*, 409 U.S. 322, 335 (1973) (tax system largely depends upon self-reporting); see also S. REP. NO. 94-938, at 317 (1976), *reprinted in* 1976 U.S.C.C.A.N. 3740, 3747 (discussing amendments to taxpayer confidentiality provisions in section 6103 as designed to protect integrity of voluntary assessment, a cornerstone of the federal income tax).

not work, those that do pay taxes will question the need for continued compliance.<sup>213</sup> But there is no proof that complexity is affecting voluntary compliance. To be fair, there is no proof of any kind regarding voluntary compliance since 1988, although the Service's National Research Program intends to remedy this fairly soon.<sup>214</sup> The absence of more recent proof is due to the Service's abandonment of the Taxpayer Compliance Management Program.<sup>215</sup> If one assumes that the Code has become more complex over time, the Service data up to 1988 suggested that increasing complexity had no measurable effect on voluntary compliance. Although the "tax gap," the excess of the amount of income tax owed by taxpayers in a given year over the amount of income tax voluntarily reported and paid by taxpayers in that same year, grew somewhat steadily over the years measured, the growth was "due in large part to the growth of income tax liabilities through real expansion of the economy and through inflation."<sup>216</sup> Further, the Service attributes variances in the voluntary compliance rate of individual taxpayers to changing economic conditions. In years of economic prosperity, voluntary compliance is higher; in years of economic recession, voluntary compliance suffers.<sup>217</sup> Interestingly, the Service predicted in 1988 that voluntary compliance would improve by 1992 due to reduced tax rates brought about by the Tax Reform Act of 1986 since that same legislation repealed or limited many deductions, "thereby minimizing the possibility for taxpayers to overstate these income offsets."<sup>218</sup> No mention of the complexity of

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<sup>213</sup> The headline of a 2001 magazine article on taxpayer cheating says it all: Janet Novack, *Are You a Chump?*, FORBES, Mar. 5, 2001, at 122. The cover of the magazine enticed readers in large print: "How to Cheat on Your Taxes."

<sup>214</sup> See GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, TAX ADMINISTRATION: STATUS OF IRS' EFFORTS TO DEVELOP MEASURES OF VOLUNTARY COMPLIANCE 3 (2001); see also News Release #IR-2002-05, Internal Revenue Service, IRS Moves to Ensure Fairness of Tax System; Research Program Works to Increase Compliance Program Effectiveness, Reduce Burdens on Taxpayers (Jan. 16, 2002), available at <http://www.irs.gov/pub/irs-soi/newsrelease-ir-02-05.pdf> (announcing intention to reestablish research on taxpayer compliance).

<sup>215</sup> GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, TAX ADMINISTRATION: STATUS OF IRS' EFFORTS TO DEVELOP MEASURES OF VOLUNTARY COMPLIANCE 4 (2001).

<sup>216</sup> INTERNAL REVENUE SERVICE, PUBLICATION 7285: INCOME TAX COMPLIANCE RESEARCH, GROSS TAX GAP ESTIMATES AND PROJECTIONS FOR 1973-1992, at 7 (1988).

<sup>217</sup> *Id.* at 8.

<sup>218</sup> *Id.* One could argue that the result of complexity is a high number of deductions available to taxpayers. This creates more opportunities for understating income (by overstating the benefit of these deductions), which in turn reduces

the tax laws arises.

In a 1995 report, however, the General Accounting Office (GAO) listed tax law complexity as a factor contributing to the tax gap.<sup>219</sup> Other factors listed in the report included collection of the tax from several sources, lack of information provided to taxpayers, and delay in resolving compliance disputes.<sup>220</sup> In a 1997 statement before the National Commission on Restructuring the Internal Revenue Service, one GAO official acknowledged the existence of Service data showing that the overall compliance rate has remained more or less constant.<sup>221</sup> All of this information suggests one of two mutually exclusive conclusions. The first possible conclusion is that any degree of complexity will cause a relatively fixed amount of noncompliance by taxpayers. After all, the compliance rate has remained constant, and one can hardly say that the same degree of complexity has afflicted the Code over the years at issue. The other possible conclusion is that complexity does not affect compliance. If one accepts the premise that the tax laws must necessarily be somewhat complex given the large number of taxpayers and the nature of the various tax bases,<sup>222</sup> then either conclusion suggests that simplifying the tax laws will have little effect on the rate of voluntary compliance.<sup>223</sup>

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taxpayer compliance. This syllogism assumes that taxpayers will falsely claim deductions “because they are there.” It is just as plausible to assume that a taxpayer will understate income regardless of the number of deductions available for the taking.

<sup>219</sup> GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, REDUCING THE TAX GAP—RESULTS OF A GAO-SPONSORED SYMPOSIUM (1995).

<sup>220</sup> *Id.*

<sup>221</sup> GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, TAXPAYER COMPLIANCE: ANALYZING THE NATURE OF THE INCOME TAX GAP (1997).

<sup>222</sup> *See supra* Parts II.A.3., II.A.6.

<sup>223</sup> At least one commentator suggests that increasing audit rates will do more to increase taxpayer compliance rates. *See* Cohen, *supra* note 114, at 117.

There is evidence, however, that simplification measures already incorporated into the Code have inadvertently increased the overall taxpayer compliance rate. According to a recent report by the GAO, more than 500,000 taxpayers claimed the standard deduction in 1998, when in fact those taxpayers would have reduced their income tax liabilities by itemizing their deductions instead of claiming the standard deduction. GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, ESTIMATES OF TAXPAYERS WHO MAY HAVE OVERPAID FEDERAL TAXES BY NOT ITEMIZING (2001). Congress introduced the standard deduction to simplify the burden of taxpayer compliance. *See* Robert S. McIntyre & Michael J. McIntyre, *Fixing the “Marriage Penalty” Problem*, 33 VAL. U. L. REV. 907, 916 (1999). Apparently, then, half a million taxpayers are content to pay extra tax

### C. Complexity Increases Administrative Costs

Taxpayers are not the only parties that have to spend money to cope with new and complex laws. With every significant change in the Code, the Service must retrain employees, change its computer programs, and, sometimes, change forms and publications.<sup>224</sup> Further, Treasury often must publish regulatory guidance to assist taxpayers and their advisers in applying a complex Code provision.<sup>225</sup> Combined, these administrative costs make tax collection less efficient than would be the case if tax laws were simpler. The Joint Committee Report also argues that complexity may be a cause of requests for higher budgets and personnel levels at the Service.<sup>226</sup> It further suggests that tax complexity accounts for the lower-than-expected accuracy rates in Service responses to technical questions from taxpayers.<sup>227</sup>

There can be no doubt that complexity does increase

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because they either do not want to take the time to itemize deductions or because they lack sufficient documentation to support such deductions. Even the Joint Committee Report acknowledges that the compliance rate may be enhanced (albeit unintentionally) by a rule designed to simplify the tax reporting process. 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 102 (Joint Comm. Print 2001). This is a damning indictment of the standard deduction, and proof that simplification can sometimes create the desired end (increased compliance) through the wrong means (tricking taxpayers into claiming a lesser amount of deductions).

The Joint Committee Report also suggests that tax complexity inadvertently boosts the compliance rate because intimidated taxpayers are more likely to take overly conservative reporting positions in order to avoid a potential dispute with the Internal Revenue Service. *Id.* But unlike the empirical evidence condemning the standard deduction, the Joint Committee Report lacks evidence to prove this claim. If the Joint Committee Report is correct, however, then perhaps simple and complex tax laws may wrongly increase overall compliance rates, in which case there is still no reason to prefer simplification.

<sup>224</sup> See McCaffery, *supra* note 5, at 1291; *supra* Part II.A.2.

<sup>225</sup> See *supra* Part II.B.3.

<sup>226</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 110.

<sup>227</sup> *Id.* (citing GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, TAX ADMINISTRATION: ASSESSMENT OF IRS' 2000 FILING SEASON 10-14 (2000)). The GAO report states that taxpayers received accurate information from the Service 73.8% of the time for the 1999 filing season and 71.9% of the time for the 2000 filing season. These percentage levels were below Service goals of 85% for 1999 and 80% for 2000. *Id.*

administrative costs, but one must be careful not to overstate its impact. Perhaps more than complexity, frequent change in the tax law impedes efficient administration.<sup>228</sup> Every significant change in the tax law – whether it simplifies or complicates the Code – requires internal change at the Service. Imagine the amount of work facing Treasury and the Service if Congress actually enacted all 127 recommendations for simplification offered in the Joint Committee Report! If the tax law were to remain constant for a meaningful period of time, then simpler laws would reduce the overall administrative burden.

As for the burden of supplying taxpayers with more information, it appears that the overall amount of guidance provided by Treasury and the Service has been relatively stable for the past decade. Consider the amount of guidance furnished to taxpayers from 1990 to 1998, set forth below in Table One.

TABLE ONE

GUIDANCE PROVIDED TO TAXPAYERS BY TREASURY AND IRS,  
1990-1998<sup>229</sup>

Type of Guidance	1990	1991	1992	1993	1994	1995	1996	1997	1998
Revenue Rulings	112	70	112	94	82	85	65	57	62
Revenue Procedures	67	74	108	53	81	58	66	61	65
Notices	75	44	61	60	103	67	68	77	67
Treasury Decisions	47	54	74	49	72	58	58	52	50
Proposed Regulations	48	83	67	57	53	49	49	46	53
Announcements	0	0	0	0	0	0	0	0	114
Private Letter Rulings	3456	2586	2273	2211	2068	2036	2022	2052	2222
Technical Advice Memos	124	201	253	173	161	153	154	149	119
Field Service Advice	195	150	399	491	397	300	220	292	258
<b>Total</b>	<b>4124</b>	<b>3262</b>	<b>3347</b>	<b>3188</b>	<b>3017</b>	<b>2806</b>	<b>2702</b>	<b>2786</b>	<b>3010</b>

Table One suggests no link between complexity and the amount of guidance furnished by the government to taxpayers. If tax complexity has been increasing over time, and if there is a link between tax

<sup>228</sup> See *supra* Part II.A.2.

<sup>229</sup> GENERAL ACCOUNTING OFFICE, INTERNAL REVENUE SERVICE, INFORMATION ON THE FEDERAL TAX SYSTEM, in 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, app. C, at C-1, C-36 to C-37.

complexity and the amount of guidance the government must supply to taxpayers, one would expect to see the total amount of guidance increase over time. Instead, the amount of guidance has varied considerably from year to year. Several reasons may account for the variance, including different budgets and personnel appropriations, as well as different administrative policies regarding the scope of advice given to taxpayers. Treasury has perhaps decided it is wiser to make fewer of its internal decisions public.<sup>230</sup>

If tax complexity has grown over time and causes taxpayers to seek more guidance from the government, one would expect the number of private letter rulings to increase from year to year.<sup>231</sup> Again, as with other categories of guidance, the number of private rulings has varied from year to year.<sup>232</sup> Such variance suggests that tax complexity does not significantly affect the amount of guidance the government furnishes to taxpayers. Thus, the alleged administrative burden is not as great as one would expect.

#### *D. Complexity Increases the Recordkeeping Burden and Compliance Costs to Taxpayers*

The burden of complexity to taxpayers is often expressed in terms of time and dollars. As the tax laws become more complicated,

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<sup>230</sup> The Service's Income Tax and Accounting branch decided to end its practice of issuing field service advice because these publicly available documents often revealed the Service's case strategies and other information that it did not want to be made public. The field service advice document has been replaced with a more conservative "background advice memorandum" (BAM) that contains only a general description of the legal questions present in the case at issue. Confidential information will be issued in a "strategic advice memorandum" (SAM), which the Service does not intend to publish for the general public. See John Almeras & Heather Bennett, *TEI Conference: TAM, SAM, BAM – The New IRS?*, 97 TAX NOTES 198 (Oct. 14, 2002).

<sup>231</sup> Private letter rulings are the method by which taxpayers can get advance rulings on various transactions. The Service refuses to offer private letter rulings on certain issues. Rev. Proc. 2003-3, 2003-1 I.R.B. 113. Taxpayers seeking a private letter ruling typically pay a user fee. Rev. Proc. 2003-1, 2003-1 I.R.B. 1 app. A (general fee of \$6000, but fee is reduced to \$500 for requests involving either a personal tax issue from an individual with gross income of less than \$250,000 or a business tax issue from a person with gross income of less than \$1 million). Private letter rulings bind the Service only as to the requesting taxpayer; other taxpayers may not rely on a private letter ruling as authority, and private letter rulings may not be cited as precedent before the United States Tax Court. Rev. Proc. 2003-1, 2003-1 I.R.B. 1; see also I.R.C. § 6110(k)(3) (written determinations not precedent).

<sup>232</sup> See Table One accompanying *supra* note 229.

taxpayers need to spend more time keeping proper records, learning about the law, preparing the proper forms and returns, and sending required documents to the Service.<sup>233</sup> Additionally, taxpayers need to spend more and more money for the advice of tax professionals, including accountants and lawyers specially trained in matters of tax compliance and planning. These burdens on taxpayers receive criticism because they are inefficient and likely to breed noncompliance.<sup>234</sup>

The Joint Committee conceded that measuring the burden of complexity on taxpayers is an inexact science.<sup>235</sup> In support of its assertion that complexity requires more and more time of taxpayers, the Joint Committee Report cited<sup>236</sup> the Service's estimates of the time required for individuals to file the most common return for individuals, Form 1040.<sup>237</sup> The Joint Committee Report does not, however, consider how the estimated time burden has changed over the last several years. Table Two sets forth the Service's estimated time required to prepare, complete, and file the Form 1040 for each of the last several years.

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<sup>233</sup> For the argument that expanding tax withholding rules to include interest, dividends, and other taxable distributions from institutional payors would exempt 50% to 80% of taxpayers from filing returns, see Snoe, *supra* note 6, at 111-15.

<sup>234</sup> See, e.g., McCaffery, *supra* note 5, at 1297-98; Pollack, *supra* note 4, at 352-53 & n. 124, 356 & n. 135; Schenk, *supra* note 31, at 166-67.

<sup>235</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 6, 103 (Joint Comm. Print 2001).

<sup>236</sup> *Id.* at 103-04.

<sup>237</sup> In 1998, Form 1040 was used by 62% of U.S. residents filing returns. See Gale, *supra* note 9, at 1474. Other individual income tax forms include Form 1040-A (used by 21% of individual taxpayers), and Form 1040-EZ (used by 17% of individual taxpayers). *Id.* Approximately 8% of U.S. residents use the Form 1040 even though they are eligible to use the simpler Form 1040-A or the even easier Form 1040-EZ. *Id.* This suggests that to some extent, simplification efforts are for naught – even when easier compliance avenues are made available, a significant number of taxpayers fail to utilize them, possibly due to a lack of knowledge or simply apathy.



TABLE TWO

ESTIMATED TIME TO COMPLETE FORM 1040, INDIVIDUAL INCOME  
TAX RETURN<sup>238</sup>  
(ALL TIMES EXPRESSED IN HOURS:MINUTES)

Year	Record- Keeping	Learning about the Law and the Form	Preparing Form	Copying, Assembling, and Sending Form to IRS	Total
1990	3:08	2:33	3:17	0:35	9:33
1991	3:08	2:31	3:23	0:41	9:43
1992	3:08	2:42	3:37	0:49	10:16
1993	3:08	2:47	3:44	0:53	10:32
1994	3:08	2:53	4:41	0:53	11:35
1995	3:08	2:54	4:43	0:53	11:38
1996	3:08	2:32	4:33	0:40	10:53
1997	3:08	2:07	3:59	0:40	9:54
1998	3:34	2:25	4:55	0:40	11:34
1999	3:15	2:39	6:22	0:35	12:51
2000	2:45	3:25	6:16	0:35	12:57
2001	2:46	3:30	6:37	0:34	13:27
2002	2:46	3:45	6:05	0:34	13:10

Table Three also presents time estimates for Form 1120, the basic corporate income tax return.<sup>239</sup>

<sup>238</sup> The Service's time estimates are set forth in the instructions accompanying the Form 1040. The data for Table Two therefore was assembled from the Instructions to the Form 1040 for each year from 1990 to 2002. See INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, INSTRUCTIONS TO FORM 1040 (1990-2002).

<sup>239</sup> Other corporate income tax returns include the Form 1120-S for S corporations, the Form 1120-A (a short form for certain corporations), and the Form 1120-F for foreign corporations. For all corporate taxpayers in 1998, the Form 1120-S was the most common one used (53.57% of all corporate income tax returns), followed by the Form 1120 (41.70%), and then the Form 1120-A (4.37%). See Patrice Treubert & William P. Janquet, *Corporation Income Tax Returns, 1998*, 21 STAT. INCOME BULL. 67 & fig. A (2001), available at <http://www.irs.gov/pub/irs-soi/98corart.pdf>.

TABLE THREE

ESTIMATED TIME TO COMPLETE FORM 1120, CORPORATE INCOME  
TAX RETURN<sup>240</sup>  
(ALL TIMES EXPRESSED IN HOURS:MINUTES)

Year	Record-Keeping	Learning about the Law and the Form	Preparing Form	Copying, Assembling, and Sending Form to IRS	Total
1990	68:24	39:51	70:38	8:02	186:55
1991	68:10	39:51	70:39	8:02	186:42
1992	68:24	39:51	70:38	8:02	186:55
1993	71:16	40:21	71:13	8:02	190:52
1994	71:16	41:08	72:02	8:02	192:28
1995	71:59	41:58	71:59	7:47	193:43
1996	71:31	41:46	71:46	7:47	192:50
1997	71:31	41:46	71:02	7:47	192:06
1998	71:59	41:10	71:08	7:47	192:04
1999	71:59	41:10	71:08	7:47	192:04
2000	71:30	42:02	72:58	8:02	194:32
2001	71:18	43:29	75:24	8:18	198:29
2002	71:18	43:29	75:24	8:18	198:29

Both Table Two and Table Three show that the average time burden for both individual and corporate taxpayers has increased since 1990. Comparing 1990 against 2002, the estimated average time for an individual to complete the Form 1040 increased by nearly four hours (more than 40% more time), and the average time for a corporation to complete the Form 1120 increased by more than 11.5 hours (an increase of only 6%). It is worth noting that the estimated total time for individuals has varied over that eleven-year period. The largest one-year increases in total time for individuals occurred between 1993 and 1994, 1997 and 1998, 1998 and 1999, and 2000 and 2001. Not surprisingly, Congress enacted significant tax legislation in 1993,<sup>241</sup> 1997,<sup>242</sup> 1998,<sup>243</sup> and 2001<sup>244</sup> that changed a number of rules affecting

<sup>240</sup> As with Table Two, the data for Table Three was derived from the Service's estimates set forth in the Instructions to the Form 1120 for each of the years 1990-2002. See INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, INSTRUCTIONS TO FORM 1120 (1990-2002).

<sup>241</sup> See Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.

<sup>242</sup> See Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

many individual taxpayers. The estimated average total time for individuals dropped in 1995 and again in 1996. This was not the result of tax law simplification, as Congress made no significant changes to the Code during those years. Perhaps it was the result of tax laws being consistent. The ever-shifting nature of federal tax laws may impose greater burdens on taxpayers than the overall complexity of the Code does. The limited data available supports such an interpretation.

Another significant trend reflected in Table Two is the reduced record-keeping burden on taxpayers. According to the Service's estimates reflected in Table Two, individual taxpayers need not spend as much time keeping proper records to comply with federal income tax laws as they once did. The Joint Committee, however, concluded that changes in the law have increased burdens to the taxpayers by adding provisions for which taxpayers must retain records.<sup>245</sup>

Perhaps this analysis gives the Service's estimates more weight than they are due. Even the Service has acknowledged that the formulae used to compute the estimates have shortcomings.<sup>246</sup> This is the only empirical data the government has regarding the time burden to taxpayers, and it suggests no causal link between complexity and the time spent completing returns.<sup>247</sup> In any event, the Joint Committee Report was remiss in not considering the estimates over a period of time and did not credibly support its conclusions as to the taxpayer compliance burden.

Another point used to suggest an increased burden on taxpayers

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<sup>243</sup> See Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685.

<sup>244</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38.

<sup>245</sup> See 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 103, 106 (Joint Comm. Print 2001).

<sup>246</sup> The four general criticisms of the models used to estimate the time burden for returns are: (1) the taxpayer survey data is old; (2) certain components of burden, including post-filing burdens, are excluded from the formulae; (3) the determinants of burden are given "simplistic treatment"; and (4) the estimates have questionable statistical validity because of poor documentation. See GENERAL ACCOUNTING OFFICE REPORT TO THE CHAIRMAN, SENATE COMM. ON SMALL BUS., TAX ADMINISTRATION: IRS IS WORKING TO IMPROVE ITS ESTIMATES OF COMPLIANCE BURDEN 18-19 (2000); see also GENERAL ACCOUNTING OFFICE, INFORMATION RELATED TO THE SCOPE AND COMPLEXITY OF THE FEDERAL TAX SYSTEM 75 (2001).

<sup>247</sup> Other studies were analyzed in Gale, *supra* note 9, at 1472-74.

is that taxpayers are spending more money to retain the assistance of professional tax advisers. As proof of the increased compliance cost to taxpayers, the Joint Committee Report cited an Internal Revenue Service comparison of individual income tax returns filed in 1990 and 1999. Professionals prepared 55% of all individual income tax returns filed in 1999, compared to only 48% of individual returns filed in 1990.<sup>248</sup> The data also shows a significant increase in the percentage of returns prepared using computer software programs (46% of returns filed in 1999 compared to 16% of returns filed in 1990) and in the percentage of returns filed electronically (17% in 1999 compared to 4% in 1990).<sup>249</sup> The Joint Committee Report suggested that increased tax complexity may be one reason for the increased reliance on paid preparers, but it conceded that taxpayers might employ professionals because the value of the taxpayer's time that he or she would expend exceeds the cost of the preparer's total fee.<sup>250</sup>

The increased use of computer software programs to complete individual returns also fails to prove that the burdens on taxpayers have increased. As the Joint Committee Report has acknowledged, the use of computer software reduces the time it takes taxpayers to perform calculations and to learn about the law,<sup>251</sup> which hardly suggests that taxpayers find the law too difficult or too costly for adequate compliance. The increased use of electronic filing also suggests that total compliance time is diminishing, leading the Joint Committee Report to infer that the Service's estimated average compliance times are inflated.<sup>252</sup> Yet all of this data supports a conclusion completely opposite to the one reached by the Joint Committee Report: taxpayers are finding ways to reduce their compliance burdens and are taking advantage of easier compliance alternatives. Certainly, the Treasury and the Service should be

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<sup>248</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 105; *see also* Gale, *supra* note 9, at 1474 ("In 1998, 53 percent of tax filers used paid preparers.").

<sup>249</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 105.

<sup>250</sup> *Id.* Additionally, some individuals might enlist paid preparers to get refunds more quickly through electronic filing. Gale, *supra* note 9, at 1474.

<sup>251</sup> 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 106.

<sup>252</sup> *Id.*

encouraged to continue providing alternative and increasingly efficient means for taxpayer compliance, which is not the same as saying that the Code and regulations are too complex. The ever-increasing complexity of the federal tax laws has had no distinctly discernible effect on the costs (time or dollars) of compliance.

*E. Complexity Fosters Disputes Between Taxpayers and the Internal Revenue Service*

The argument here is that complexity invites dispute. If the laws are too vague, disputes between taxpayers and the Service are inevitable.<sup>253</sup> On the other hand, if the laws are too technical, disputes may arise as to the applicability of a particular provision to a given case.<sup>254</sup> If this argument were true, one would expect to see more disputes over time, again assuming that the tax laws become more complex (either more vague, more technical, or both) over time. In fact, however, the number of litigated disputes between taxpayers and the Service has been decreasing over the last decade. Data from the Service's Chief Counsel shows that the total number of tax cases has decreased from about 57,400 in 1990 to only 23,800 in 1999.<sup>255</sup> The decrease is likely the result of numerous attempts by the Service to reduce taxpayer disputes through various compromise programs. It may also reflect reduced audit rates over that same period.<sup>256</sup> Finally, the reduced caseload may indicate that statutory solutions to tax shelter activities have been successful in preventing disputes. One could argue that, absent these extra measures from the Service to reach compromise and absent the reduced audit rates, the number of tax cases would be much higher perhaps due to tax complexity. The Joint Committee Report offers no such argument, probably due to the lack of evidence to support it.

Upon closer scrutiny, the purported disadvantages of tax complexity do not seem very substantial. Tax complexity is not as harmful as one might think, and, as shown earlier, many of the causes of tax complexity will not disappear anytime soon. In light of these

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<sup>253</sup> See Miller, *supra* note 76, at 20.

<sup>254</sup> See Pollack, *supra* note 4, at 349-50.

<sup>255</sup> GENERAL ACCOUNTING OFFICE, INFORMATION ON THE FEDERAL TAX SYSTEM 36-37 (2001); see also 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 123.

<sup>256</sup> See *supra* note 115 (noting steady decline in audit rates for past few years).

conclusions, one must wonder why tax simplification is gaining so much momentum in contemporary policy debates.

#### IV. PROPOSALS FOR TAX SIMPLIFICATION

Although the analysis to this point seriously questions the need to remedy tax complexity, the Joint Committee Report and other advocates have offered various proposals for simplifying the tax laws. Part IV will analyze three of the more significant proposals made by the Joint Committee Report: the repeal of the alternative minimum tax (AMT), the restructuring of the treatment of capital gains, and the repeal of income-based phaseouts and phaseins.

##### A. *Alternative Minimum Tax*

The AMT is a backstop measure designed to ensure that wealthy taxpayers pay at least a certain “minimum” amount of income tax.<sup>257</sup> The history of the AMT is an epic saga spanning over thirty years.<sup>258</sup> Its history not only serves as helpful background but also as an illustration of increasing tax complexity in action.<sup>259</sup>

In the late 1960s, Congress became concerned that some wealthy taxpayers were making what it considered an excessive use of various exclusion and deduction provisions to minimize tax liability.<sup>260</sup> The tax liabilities of taxpayers with equivalent incomes varied significantly because of these “tax preference items.”<sup>261</sup> In many cases, wealthier

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<sup>257</sup> See S. REP. NO. 99-313 (1986); see also H.R. REP. NO. 99-426 (1985); JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ISSUES RELATING TO THE INDIVIDUAL ALTERNATIVE MINIMUM TAX (AMT) (Joint Comm. Print 1998).

<sup>258</sup> See generally 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 2-6.

<sup>259</sup> Professor Pollack argues the evolution of the AMT “reflects the worst tendency of incremental policymaking—tinkering with change at the margins rather than confronting the underlying problems.” Pollack, *supra* note 4, at 346.

<sup>260</sup> JOINT COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 105 (Joint Comm. Print 1970).

<sup>261</sup> The first items of tax preference were: (1) the excess of investment interest expenses then allowed as a deduction over net investment income; (2) accelerated depreciation of real property; (3) accelerated depreciation of personal property subject to a net lease; (4) the excess depreciation deduction then allowed to certain pollution control facilities; (5) the excess depreciation deduction then allowed for railroad rolling stock; (6) the difference between the fair market value of a qualified or restricted stock option and its exercise price; (7) excessive bad debt reserves for

taxpayers exploited tax preference items, which allowed them to pay tax at a lower effective rate than taxpayers with substantially less income.<sup>262</sup> In some extreme cases, wealthy individual and corporate taxpayers paid no tax at all.<sup>263</sup> A crisis of horizontal and vertical equity occurred.<sup>264</sup> Congress had three options in responding to the crisis: (1) do nothing and accept the disparate tax treatments as a justifiable departure from horizontal and vertical equity, (2) limit the benefit of each tax preference item available to wealthier taxpayers (perhaps by phaseout provisions or flat ceilings), or (3) impose an additional tax liability on wealthy taxpayers who claim an excessive amount of tax preference items. Congress opted for the last option, enacting an “add-on minimum tax” as part of the Tax Reform Act of 1969.<sup>265</sup> The add-on minimum tax base was the sum of tax preference items claimed by a taxpayer minus an exemption amount of, in most cases, \$30,000.<sup>266</sup> The tax was then 10% of the tax base.<sup>267</sup> In computing the total tax due, the add-on minimum tax liability increased the taxpayer’s regular tax liability.<sup>268</sup> Of course, the add-on minimum tax contributed to tax complexity since wealthy taxpayers had to perform additional computations and plan for possible application of an additional tax. Again, simplicity took a back seat to equity, but Congress was apparently happy to make the sacrifice.<sup>269</sup>

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financial institutions; (8) the depletion deduction for timber, mineral, and oil and gas properties; and (9) one-half of an individual taxpayer’s net capital gain. Tax Reform Act of 1969, Pub L. No. 91-172, § 301, 83 Stat. 487, 581-82 (codified as amended in scattered sections of 26 U.S.C.).

<sup>262</sup> JOINT COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, at 105.

<sup>263</sup> *Id.*; see also Shirley A. Jones, *The Evolution of the Corporate Minimum Tax*, 20 J. CORP. TAX’N. 351, 351 (1994) (noting a 1969 Treasury study that found “154 returns filed in 1966 reported gross incomes of \$200,000 or more on which no federal income taxes were paid”).

<sup>264</sup> Indeed, there was also a crisis of efficiency, in the neutrality sense of the term. Obviously many wealthy taxpayers were altering their behavior to take advantage of the tax preference items.

<sup>265</sup> Tax Reform Act of 1969 § 301.

<sup>266</sup> *Id.*

<sup>267</sup> *Id.*

<sup>268</sup> *Id.*

<sup>269</sup> Others have indirectly argued that imposing an additional tax on those who legally claim tax benefits to which they are entitled is poor policy. See generally Robert J. Peroni, *Back to the Future: A Path to Progressive Reform of the U.S. International Income Tax Rules*, 51 U. MIAMI L. REV. 975, 1001 (1997); Pollack, *supra* note 4, at 345-46. These scholars would limit each of the tax preference items separately so that there is no need for an additional tax. As discussed later, though,

Within a few years, however, taxpayers subject to the additional tax found ways to circumvent the add-on minimum tax.<sup>270</sup> In the Tax Reform Act of 1976, Congress strengthened the add-on minimum tax by expanding the list of tax preference items, increasing the tax rate to 15%, and reducing the exemption amount.<sup>271</sup> By enlarging the scope of the add-on minimum tax, both in the number of tax preference items and in the number of taxpayers subject to the tax, Congress increased tax complexity. Congress found the added complexity necessary to achieve the equity correction it originally sought.<sup>272</sup>

The reforms introduced in 1976 were short-lived. By 1978, Congress determined that the add-on minimum tax was adversely affecting market decisions, specifically capital formation.<sup>273</sup> In the Revenue Act of 1978,<sup>274</sup> Congress created a new “alternative minimum tax” for the capital gains deduction<sup>275</sup> and for excess itemized deductions.<sup>276</sup> Congress did preserve the add-on minimum tax for all other tax preference items. Under the first AMT, “alternative minimum taxable income” in excess of \$20,000 was

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tailoring each tax preference item separately would be less palatable not only because of the added complexity but also because it would overcorrect the problem by subjecting more taxpayers to adjustments. *See infra* note 312 and accompanying text.

<sup>270</sup> JOINT COMM. ON TAXATION, 94TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 105, 107 (Joint Comm. Print 1976) (pertaining to individuals and corporations, respectively).

<sup>271</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, § 301, 90 Stat. 1520, 1549 (codified as amended in scattered sections of 26 U.S.C.).

<sup>272</sup> In this regard, the 1976 amendments to the Code are examples of Congress repairing defective legislation. *See supra* Part II.A.7.

<sup>273</sup> JOINT COMM. ON TAXATION, 95TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 261 (Joint Comm. Print 1979).

<sup>274</sup> Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763 (codified as amended in scattered sections of 26 U.S.C.).

<sup>275</sup> Under prior law, individual taxpayers deducted one-half of the net capital gain in determining taxable income. In effect, then, capital gains were always taxed at an effective rate of one-half of the taxpayer’s marginal tax rate. Thus, capital gains in the hands of a taxpayer with a marginal tax rate of 40% would be subject to tax at a rate of 20%. For more on the deduction for capital gains as an alternative to the preferential tax rates under current law, see *supra* Part IV.B.

<sup>276</sup> Individuals can choose to compute taxable income using either the standard deduction or by itemizing all other deductions not allowed in computing adjusted gross income. I.R.C. § 63(a)-(b). As a practical matter, taxpayers should itemize when the total amount of itemized deductions exceeds the standard deduction amount. In fact, however, taxpayers may be claiming the standard deduction merely for convenience. *See supra* note 223.



subject to marginal tax rates ranging from 10% to 25%.<sup>277</sup> If the AMT liability exceeded the sum of the taxpayer's regular tax and add-on minimum tax liabilities, the taxpayer paid the AMT liability instead of the other taxes.<sup>278</sup> Congress designed the first AMT to affect the total tax liability only of those taxpayers with incomes over \$50,000.<sup>279</sup> By customizing its reform efforts to impact only wealthier taxpayers, Congress contributed to tax complexity. Now there were two surcharge taxes, not one. Although the new AMT only taxed wealthier taxpayers who made excessive use of two tax preference items, many had to determine whether either or both the AMT and the leftover add-on minimum tax applied to them. Mass complexity increased slightly, and specific complexity for those likely subject to the AMT increased significantly.<sup>280</sup>

The two-tax surcharge regime only lasted four years. Congress repealed the add-on minimum tax for individuals in the Tax Equity and Fiscal Responsibility Act of 1982.<sup>281</sup> The tax preference items subject to the add-on minimum tax became subject to the AMT.<sup>282</sup> Congress also increased the AMT exemption amount to \$30,000 (or \$40,000 for couples filing a joint return).<sup>283</sup> The intent of the 1982 reforms was to reduce the scope of the AMT.<sup>284</sup> Again, the tax was supposed to affect only those with incomes over \$50,000.<sup>285</sup> Congress also hoped to simplify taxpayer computations by consolidating two surcharge taxes into one.<sup>286</sup> Interestingly, the add-on minimum tax continued to apply to corporate taxpayers, with no explanation as to why the complexity burden was acceptable for corporations. Since Congress reduced the scope of the AMT, one would expect the AMT to be less effective in preventing taxpayers from making excessive use

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<sup>277</sup> Revenue Act of 1978 § 421, 92 Stat. at 2871-72.

<sup>278</sup> *Id.* The current AMT liability is calculated in the same manner. I.R.C. § 55(a).

<sup>279</sup> JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE ACT OF 1978, at 262 (Joint Comm. Print 1979).

<sup>280</sup> For a discussion of the trade-off between mass complexity and specific complexity, see *supra* Part II.A.4.

<sup>281</sup> Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

<sup>282</sup> *Id.* § 201, 96 Stat. at 411-12.

<sup>283</sup> *Id.* § 201, 96 Stat. at 416.

<sup>284</sup> JOINT COMM. ON TAXATION, 97TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, at 18 (Joint Comm. Print 1982).

<sup>285</sup> *Id.*

<sup>286</sup> *Id.*

of exclusions, deductions, and credits.

By 1986, the prediction of limited effectiveness had come true. Congress had become concerned that the AMT omitted many tax preference items and allowed many wealthy taxpayers to continue paying less than a “fair” amount of tax.<sup>287</sup> As part of the Tax Reform Act of 1986,<sup>288</sup> Congress added to the list of tax preference items subject to the AMT<sup>289</sup> and substituted a flat AMT rate of 21%.<sup>290</sup> Corporate taxpayers became subject to the AMT (but at a flat rate of 20%<sup>291</sup>), and Congress fully repealed the add-on minimum tax.<sup>292</sup> Only four years after limiting the scope of the AMT to reduce mass complexity, Congress realized that simplification frustrated the overall purpose of the AMT. It deliberately decided to restore complexity in order to advance the equity sought by the AMT.

In the next decade, Congress twice raised the AMT rate for individuals<sup>293</sup> but otherwise left the AMT alone. With the Taxpayer Relief Act of 1997, Congress made two significant changes to the AMT.<sup>294</sup> First, it modified the adjustment made to depreciation deductions with respect to property placed in service after December 31, 1998.<sup>295</sup> The modification served to curtail AMT liability attributable to the accelerated depreciation deductions available to taxpayers because Congress determined that such liability was impeding capital formation and business operations.<sup>296</sup> Second, Congress repealed the AMT for corporations with average annual

<sup>287</sup> JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 432-33 (Joint Comm. Print 1987).

<sup>288</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

<sup>289</sup> *Id.* § 701, 100 Stat. at 2333-35 (adding tax-exempt interest and the fair market value deduction for charitable contributions of appreciated property to the list of preference items).

<sup>290</sup> *Id.* § 701, 100 Stat. at 2321.

<sup>291</sup> *Id.*

<sup>292</sup> *See generally id.*, 100 Stat. at 2320-39.

<sup>293</sup> The Omnibus Budget Reconciliation Act of 1990 increased the AMT rate to 24% for individuals. Pub. L. No. 101-508, § 11102, 104 Stat. 1388, 1388. The Omnibus Budget Reconciliation Act of 1993 imposed a two-tier rate structure of 26% and 28%. Pub. L. No. 103-66, § 13202, 107 Stat. 312, 461-62 (codified at I.R.C. § 55(b)(1)(A) (1993)). The first \$175,000 of “alternative minimum taxable income” in excess of the applicable exemption amount was subject to tax at 26%. *Id.* at 461. Additional amounts were taxed at 28%. *Id.* at 462.

<sup>294</sup> Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 401, 111 Stat. 788.

<sup>295</sup> *Id.* § 402, 111 Stat. at 844 (codified at I.R.C. § 56(a)(1)(A)(i) (1997)).

<sup>296</sup> JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 60 (Joint Comm. Print 1997).

gross receipts of less than \$7.5 million.<sup>297</sup> Congress cited administrative complexity as the justification for removing small corporations from the reach of the AMT.<sup>298</sup> Considering that less than 1% of all taxpayers pay AMT,<sup>299</sup> the degree of simplicity achieved by exempting small corporations is likely minimal. A better justification for the small corporation exemption is that it furthers the original purpose of the AMT. From its inception, Congress intended the AMT to reach only wealthy taxpayers, originally defined as those with incomes in excess of \$50,000.<sup>300</sup> By relieving small corporations of AMT liability, Congress preserved the limited scope while maintaining an effective deterrent for those taxpayers within its scope. Justifying the exemption as a simplification measure though would only serve to open the door to eventual repeal.

Legislation passed in 1999 and then vetoed by President Clinton would have slowly repealed the AMT for individuals altogether.<sup>301</sup> Remarkably, the 2001 Act did not contain a similar provision. The AMT saga is apparently an unfinished work. The Joint Committee Report goes a step further than the vetoed 1999 legislation: it recommends the elimination of both the individual AMT and the corporate AMT.<sup>302</sup> It justifies complete repeal on three grounds. First, the Joint Committee Report complains of the significant compliance burden placed on taxpayers, noting Service estimates that taxpayers annually devote more than 29 million hours in completing Form 6251, the AMT computation form.<sup>303</sup> There is no question that the AMT contributes to tax complexity, but at the risk of redundancy, the added complexity is acceptable if the AMT is serving important objectives. Neither the Joint Committee Report nor other advocates of repeal<sup>304</sup> question the underlying objective of the AMT.<sup>305</sup>

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<sup>297</sup> Taxpayer Relief Act of 1997 § 401, 111 Stat. at 843.

<sup>298</sup> JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 60.

<sup>299</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 17 (Joint Comm. Print 2001).

<sup>300</sup> See *supra* notes 257-63 and accompanying text.

<sup>301</sup> Taxpayer Relief Act of 1999, H.R. 2488, 106th Cong. § 121 (1999).

<sup>302</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 15.

<sup>303</sup> *Id.* at 13.

<sup>304</sup> Richard M. Lipton, Chair of the American Bar Association Section of Taxation, has called for repeal of the AMT. Richard M. Lipton, *To Simplify Code*,

Repealing the AMT solely on complexity grounds is not sufficient.

Second, the Joint Committee Report observes that the AMT, if unchanged, will reach an increasing number of taxpayers over the next ten years.<sup>306</sup> The Joint Committee Report estimates that more than 11% of taxpayers will face AMT liability in 2011<sup>307</sup> – a number far in excess of original intentions.<sup>308</sup> Taxpayers within reach of the AMT will include many middle-income taxpayers with some capital gains who also make use of many personal exemptions and the child tax credit.<sup>309</sup> This threatens horizontal equity. The growing number of taxpayers subject to the AMT is a function of several factors. In general, regular tax rates are lower now than when Congress created the AMT.<sup>310</sup> The AMT rates, however, have not changed consistently with the regular tax rates. Also, the AMT exemption amount is not subject to inflation adjustments, unlike many aspects of the regular income tax.<sup>311</sup> Congress can cure these problems without repealing the AMT. Inflation adjustments can normalize the AMT exemption amounts, and Congress can structure the AMT rate as a function of regular tax rates.<sup>312</sup> Thus, the AMT rate would rise or fall as regular tax rates rise or fall. Repealing the AMT due to its increased scope in the future would overcorrect for the problem.

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*Start by Repealing the AMT*, 91 TAX NOTES 2254 (June 25, 2001).

<sup>305</sup> For a justification of the AMT on grounds of “perceptual equity,” see Daniel N. Shaviro, *Uneasiness and Capital Gains*, 48 TAX L. REV. 393, 414 (1993).

<sup>306</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 17.

<sup>307</sup> *Id.*

<sup>308</sup> *Id.* at 15; see also Gale, *supra* note 9, at 1469.

<sup>309</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 14. Even for those taxpayers who pay no AMT, there is the added burden of completing AMT forms and worksheets to determine eligibility for the child tax credit and other nonrefundable income tax credits. See I.R.C. § 26.

<sup>310</sup> In 1969, the highest marginal tax rate for individuals was 70%. I.R.C. § 1, amended by Act of Dec. 30, 1969, Pub. L. No. 91-172, § 803(a), 83 Stat. 678-82. As a result of the 2001 Act, the highest such rate for individuals in 2001, the year of the Joint Committee Report, was only 39.1%. I.R.C. § 1(i)(2).

<sup>311</sup> See, e.g., I.R.C. §§ 1(f) (inflation adjustments to tax brackets), 63(c)(4) (inflation adjustments to amount of standard deduction), 68(a)(2) (inflation adjustments to overall limit on itemized deductions), 151(d)(4) (inflation adjustments to personal and dependency exemptions).

<sup>312</sup> Gale, *supra* note 9, at 1470; see also Oskar R. Harmon, *AMT: Why and How to Reform*, 91 TAX NOTES 667, 670 (Apr. 23, 2001).

Third, the Joint Committee Report argues that the AMT is no longer necessary now that the regular tax system contains specific provisions that accomplish the same general goal.<sup>313</sup> It cites the enactment of the passive loss rules in 1986<sup>314</sup> as evidence that the Code already contains anti-abuse provisions designed to curb tax shelter activities.<sup>315</sup> Consequently, the Joint Committee Report concludes that the regular tax base is too similar to the AMT base to warrant the imposition of a separate tax.<sup>316</sup> As the Joint Committee Report states, “legislative changes since the Tax Reform Act of 1986 . . . have had the effect of more closely conforming the regular tax base for individual taxpayers to the alternative minimum tax base.”<sup>317</sup> What the Joint Committee Report does not consider is that even if the respective tax bases are similar, the few differences may be important in preventing high-income taxpayers from paying less than an equitable amount of tax. Another interesting aspect of this argument for repeal is its apparent preference to overcorrect the perceived abuses by imposing limitations applicable to all taxpayers (like the passive loss rules) rather than to correct the problem by imposing an additional tax on the target group of abusers. Scholars already complain of the complexity of the passive loss rules.<sup>318</sup> The

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<sup>313</sup> 2 JOINT COMM. ON TAX., 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 15.

<sup>314</sup> See I.R.C. § 469. In general, the passive loss rules permit taxpayers to deduct losses from “passive activities” only to the extent of the taxpayer’s aggregate income from all “passive activities.” I.R.C. § 469(a), (d)(1). Any disallowed passive losses carry over to the next taxable year. I.R.C. § 469(b). A “passive activity,” in general, is any business activity in which the taxpayer does not “materially participate.” I.R.C. § 469(c)(1). A taxpayer is deemed to materially participate in an activity if the taxpayer meets any one of several tests contained in the Regulations. See Temp. Treas. Reg. § 1.469-5T (2003). The passive loss rules thus discourage limited participation in activities designed to generate substantial losses.

<sup>315</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 15. Another example of an anti-tax shelter provision is section 465. See I.R.C. § 465 (disallowing losses except to the extent the taxpayer is “at-risk” with respect to the loss).

<sup>316</sup> JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 15.

<sup>317</sup> *Id.*

<sup>318</sup> See generally Hymel, *supra* note 29; Miller, *supra* note 76, at 18-20; Pollack, *supra* note 4, at 339-40; Snoc, *supra* note 6, at 97-98.

Joint Committee Report's preference for mass complexity over specific complexity in the case of the AMT is curious.<sup>319</sup>

The arguments of scope and redundancy are flawed. Only the complexity argument remains. To that, the definitive response is that the complexity of the AMT is a necessary toll incurred to limit excessive use of tax preference items. The AMT acts as a watchdog to make sure taxpayers who make use of tax benefits do not benefit too much. To the extent the AMT promotes fairness and taxpayer perceptions of equity at the cost of specific complexity, the Joint Committee should rethink its recommendation for repeal.<sup>320</sup> If Congress would rather not limit each tax preference item separately because such reform would be too complicated, Congress should welcome the AMT as a simpler vehicle for fairness.

### *B. Treatment of Capital Gains*

The Code gives preferential treatment to certain gains<sup>321</sup> from the sale or exchange of capital assets<sup>322</sup> by individuals.<sup>323</sup> Such treatment

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<sup>319</sup> The Joint Committee Report offered no simplification proposals with respect to the passive loss rules, despite the criticisms of complexity. This was probably because any such proposals would profoundly affect the policy decisions underlying the Code provision, and the Joint Committee Report tried to avoid discussion of proposals that would have such an effect. See 1 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 44. But if the AMT is unnecessary because it accomplishes the same objectives as the passive loss rules, one wonders why the Joint Committee felt free to call for repeal of the AMT. Clearly, the repeal of the AMT is just as much a policy decision as simplification of the passive loss rules.

<sup>320</sup> There is no doubt, however, that the AMT is in need of reform. For example, recommendations for a deduction for contingent fees paid to attorneys should be enacted. See Laura Sager & Stephen Cohen, *Judge Posner's Failed Opinion in Kenseth*, 92 TAX NOTES 1227, 1227-28 (Aug. 27, 2001). This proposal advocates tailored reform, not over-correction.

<sup>321</sup> In order to be taxed at a reduced rate, the asset giving rise to the capital gain must have been held by the taxpayer for more than one year. I.R.C. §§ 1(h); 1222(1)-(4), (11). Holding periods are determined with reference to special operating rules set forth in section 1223. See I.R.C. § 1223. For instance, the holding period for appreciated property acquired by gift includes the donor's holding period. I.R.C. §§ 1223(2), 1015(a).

<sup>322</sup> Section 1221(a) defines a capital asset as any asset other than (1) inventory and raw materials; (2) property held primarily for sale to customers in the ordinary course of business; (3) real property used in a business; (4) depreciable personal property used in a business; (5) certain intangibles created by or for the taxpayer; (6) accounts and notes receivable from the sale of raw materials, inventory, or property

is consistent with Congress' long-standing practice of preferential treatment for these "capital gains."<sup>324</sup> The policy justifications for preferential treatment are hotly debated,<sup>325</sup> but its track record suggests Congress is very unlikely to reconsider its capital gains policy. Assuming, then, that preferential tax treatment for capital gains is a legitimate policy objective, the question becomes how to extend such treatment.

The current solution is a combination of exclusions and lower tax rates applicable to capital gains. Preferential tax rates apply to

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held for sale to customers; (7) certain governmental publications; (8) so-called "commodities derivative financial instruments" held by commodities derivatives dealers; (9) hedging transactions; and (10) supplies regularly used or consumed in the ordinary course of business. I.R.C. § 1221(a).

<sup>323</sup> I.R.C. § 1(h). Corporations receive no preferential tax treatment for capital gains. I.R.C. § 1201(a). Still, characterization of gains and losses is important for corporate taxpayers because capital losses are only deductible to the extent of capital gains. I.R.C. § 1211(a). Excess capital losses are subject to special carryback and carryover rules set forth in section 1212. *See* I.R.C. § 1212(a).

<sup>324</sup> Beginning with the Revenue Act of 1921, Congress has provided individual taxpayers with reduced rates for net capital gains. *See* Revenue Act of 1921, Pub. L. No. 67-98, § 136, 42 Stat. 227. From 1921 to 1942, capital gains were taxed at lower rates than those that applied to ordinary income. From 1942 to 1986, the Code contained no preferential rates, but individuals were permitted to exclude at least half of all capital gains and losses if the assets sold or exchanged were held for more than six months. 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 100. The Tax Reform Act of 1986 repealed all exclusions and preferential tax rates for capital gains. Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216. By 1990, however, preferential rates were restored. The Revenue Reconciliation Act of 1990 increased the maximum marginal tax rate on ordinary income to 31% but kept the rate for net capital gains at 28%. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388. The capital gains rate stayed at 28% even when Congress raised the maximum marginal tax rate on ordinary income to 39.6%. *See* I.R.C. § 1(a)-(e).

<sup>325</sup> *See, e.g.,* Noel B. Cunningham & Deborah H. Schenk, *The Case for a Capital Gains Preference*, 48 TAX L. REV. 319 (1993); Daniel Halperin, *Commentary: A Capital Gains Preference is Not EVEN a Second-Best Solution*, 48 TAX L. REV. 381 (1993); Snoe, *supra* note 6, at 66-85; Charles E. Walker & Mark A. Bloomfield, *The Case for the Restoration of a Capital Gains Tax Differential*, 43 TAX NOTES 1019 (May 22, 1989); Deborah M. Weiss, *Can Capital Tax Policy Be Fair? Stimulating Savings Through Differential Tax Rates*, 78 CORNELL L. REV. 206 (1993); Bonner Menking, Comment, *Making Sense of Capital Gains Taxation*, 39 U. KAN. L. REV. 175 (1990). For the argument that a preferential rate for capital gains is inefficient, see McCaffery, *supra* note 5, at 1295-96.

individual taxpayers with a “net capital gain,”<sup>326</sup> which by definition requires a taxpayer to have net gains from sales or exchanges of capital assets held for more than one year.<sup>327</sup> For individuals subject to the top tax brackets, the tax rate for net capital gains is generally 20%;<sup>328</sup> for taxpayers in the lower brackets, however, the net capital gain tax rate is generally 10%.<sup>329</sup> If a taxpayer in these lower brackets held a capital asset for more than five years, the tax rate drops to 8%.<sup>330</sup> Any such gain, with a holding period beginning after December 31, 2000, will even qualify wealthy taxpayers for a reduced preferential rate of 18%.<sup>331</sup> The Code taxes some capital gains at slightly higher rates, though these rates are still lower than the rates applicable to ordinary income. These special items are gains from sales and exchanges of collectibles<sup>332</sup> (taxed at 28%<sup>333</sup>) and gain attributable to unrecaptured depreciation deductions on real property<sup>334</sup> (taxed at 25%<sup>335</sup>).

In addition to preferential tax rates, an individual can sometimes exclude all or a portion of the gain realized upon the sale or exchange of a capital asset. For instance, a shareholder can exclude 50% of the gain from the sale or exchange of original issue “qualified small business stock” that he or she has held for more than five years.<sup>336</sup> The exclusion rate grows to 60% in the case of qualified small business stock in a corporation doing business within an “empowerment zone.”<sup>337</sup> Moreover, some capital gains are excluded

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<sup>326</sup> I.R.C. § 1(h).

<sup>327</sup> I.R.C. § 1222(1)-(4), (11).

<sup>328</sup> I.R.C. § 1(h)(1)(C).

<sup>329</sup> I.R.C. § 1(h)(1)(B).

<sup>330</sup> I.R.C. § 1(h)(2)(A).

<sup>331</sup> I.R.C. § 1(h)(2)(B).

<sup>332</sup> I.R.C. § 1(h)(5)-(6). For this purpose, “collectibles” include artwork, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, and other assets specifically identified as collectibles by the Secretary of the Treasury. I.R.C. § 408(m)(2).

<sup>333</sup> I.R.C. § 1(h)(1)(E).

<sup>334</sup> I.R.C. §§ 1(h)(7), 1250.

<sup>335</sup> I.R.C. § 1(h)(1)(D).

<sup>336</sup> I.R.C. § 1202(a)(1), (c)(1). One-half of the amount excluded (or 25% of the total gain) is a tax preference item for purposes of the AMT. I.R.C. § 57(a)(7). A “qualified small business” is any C corporation with aggregate gross assets of \$50 million or less before and after the stock issuance. I.R.C. § 1202(d).

<sup>337</sup> I.R.C. § 1202(a)(2). The corporation must have been a “qualified business entity” for “substantially all of the taxpayer’s holding period for such stock.” *Id.* Qualified business entities, in general, perform most of their business activities and



entirely, meaning that the effective tax rate on such gains is zero. These gains include sales of capital assets representing stock, partnership interests, or tangible property used in a business operated in the District of Columbia Enterprise Zone<sup>338</sup> and, with respect to assets acquired after 2001, those related to a business operated in a “renewal community.”<sup>339</sup>

As a result of the current hybrid system, there are eighteen possible tax rates for capital gains. Table Four summarizes the eighteen rates that were used for individual taxpayers in 2002:

TABLE FOUR<sup>340</sup>

EFFECTIVE 2002 TAX RATES APPLICABLE TO CAPITAL GAINS

Type of Capital Gain	Regular Tax Bracket <sup>341</sup>					
	10%	15%	27%	30%	35%	38.6%
Short-Term Capital Gain <sup>342</sup>	10%	15%	27%	30%	35%	38.6%
Long-Term Capital Gain <sup>343</sup>	10%	10%	20%	20%	20%	20%

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have most of their assets within one of the “empowerment zones” identified by the Secretary of Housing and Urban Development. I.R.C. §§ 1391(b), 1393(b), 1397C(b).

<sup>338</sup> I.R.C. § 1400B. The District of Columbia Enterprise Zone is, in essence, the entire District of Columbia. I.R.C. § 1400(a)-(c).

<sup>339</sup> I.R.C. § 1400F. A “renewal community” is one designated as such by the Secretary of Housing and Urban Development. I.R.C. § 1400E(a). The assets eligible for the renewal community exclusion are the same types of assets eligible for the District of Columbia Enterprise Zone exclusion. See I.R.C. §§ 1400F(a) and 1400G.

<sup>340</sup> Table Four is based upon a similar table appearing in 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 99 (Joint Comm. Print 2001).

<sup>341</sup> The six columns on the right detail the applicable capital gains rates for taxpayers in each of the six marginal tax brackets for ordinary income. Thus, for example, a taxpayer whose last dollar of ordinary income is taxed at 35% enjoys a 20% tax rate on general long-term capital gains.

<sup>342</sup> This term refers to gain from the sale or exchange of capital assets held for less than one year. I.R.C. § 1222(1).

<sup>343</sup> This term refers to gain from the sale or exchange of capital assets held for more than one year. I.R.C. § 1222(3).

TABLE FOUR, CONT.

Type of Capital Gain	Regular Tax Bracket					
	10%	15%	27%	30%	35%	38.6%
Section 1250 Gain <sup>344</sup>	10%	15%	25%	25%	25%	25%
Collectibles Gain <sup>345</sup>	10%	15%	27%	28%	28%	28%
Small Business Stock <sup>346</sup>	5%	7.5%	13.5%	13.5%	13.5%	13.5%
Small Business Stock for Empowerment Zone Business <sup>347</sup>	4%	6%	10.8%	10.8%	10.8%	10.8%
Five-Year Gain (property acquired before 2001) <sup>348</sup>	8%	8%	20%	20%	20%	20%
Five-Year Gain (property acquired after 2000) <sup>349</sup>	8%	8%	18%	18%	18%	18%
D.C. Enterprise Zone Stock and Renewal Community Stock <sup>350</sup>	0%	0%	0%	0%	0%	0%

The Joint Committee Report finds the current system too complex.<sup>351</sup> Its solution is to eliminate all preferential tax rates and to permit individual taxpayers to deduct “a fixed percentage” of their net capital gains.<sup>352</sup> The Joint Committee Report recommends retention of the exclusions for small business stock, D.C. Enterprise Zone stock, and renewal community stock.<sup>353</sup>

The Joint Committee Report does not suggest an appropriate percentage for the proposed reduction. For purposes of illustration, however, assume that Congress repealed all preferential rates and

<sup>344</sup> I.R.C. § 1(h)(1)(D), (h)(7). See *infra* notes 359-67 and accompanying text.

<sup>345</sup> This term refers to long-term capital gains from the sale or exchange of collectibles. See *supra* note 332 and accompanying text.

<sup>346</sup> This term refers to long-term capital gains eligible for the 50% exclusion under section 1202(a)(1). See § 1202(a)(1); see also *supra* note 336 and accompanying text.

<sup>347</sup> I.R.C. § 1202(a)(2); see *supra* note 337 and accompanying text.

<sup>348</sup> I.R.C. § 1(h)(2)(A); see *supra* note 330 and accompanying text.

<sup>349</sup> I.R.C. § 1(h)(2)(B); see *supra* note 330-31 and accompanying text.

<sup>350</sup> I.R.C. §§ 1400B, 1400F; see *supra* notes 338-39 and accompanying text.

<sup>351</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 102 (Joint Comm. Print 2001).

<sup>352</sup> *Id.* at 103. Other commentators support this proposal. See, e.g., Gale, *supra* note 9, at 1470.

<sup>353</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 103.

permitted individual taxpayers to deduct 40% of the net capital gain. Under the new law, individual taxpayers could face as many as twenty different effective tax rates for capital gains – two more than under the current system! This is shown in Table Five, where the 2002 tax rates for capital gains are recomputed assuming Congress adopted the Joint Committee Report proposal:

TABLE FIVE<sup>354</sup>

**EFFECTIVE 2002 TAX RATES APPLICABLE TO CAPITAL GAINS,  
ASSUMING 40% DEDUCTION FOR NET CAPITAL GAIN**

Type of Capital Gain	Regular Tax Bracket					
	10%	15%	27%	30%	35%	38.6%
Short-Term Capital Gain	10%	15%	27%	30%	35%	38.6%
Long-Term Capital Gain	6%	9%	16.2%	18%	21%	23.16%
Section 1250 Gain	6%	9%	16.2%	18%	21%	23.16%
Collectibles Gain	6%	9%	16.2%	18%	21%	23.16%
Small Business Stock	3%	4.5%	8.1%	9%	10.5%	11.58%
Small Business Stock for Empowerment Zone Business	2.4%	3.6%	6.48%	7.2%	8.4%	9.264%
Five-Year Gain (property acquired before 2001)	6%	9%	16.2%	18%	21%	23.16%
Five-Year Gain (property acquired after 2000)	6%	9%	16.2%	18%	21%	23.16%
D.C. Enterprise Zone Stock and Renewal Community Stock	0%	0%	0%	0%	0%	0%

Of course, any one taxpayer will not face more than five different rates, which under the current system is true only for taxpayers in the lowest tax bracket. The wealthiest taxpayers in the current system face up to eight different tax rates on capital gains; under the Joint Committee Report proposal, the same taxpayers face only five different rates.<sup>355</sup> While the total number of possible rates increases under the proposal, the number of tax rates facing wealthier

<sup>354</sup> The terms used in Table Five have the same meanings as those used in Table Four. See *supra* notes 341-50.

<sup>355</sup> According to Table Five, for example, a taxpayer in the 35% marginal tax bracket for ordinary income could face as many as five different rates for capital gains: 35%, 21%, 10.5%, 8.4%, and 0%. See *supra* note 354 and accompanying Table Five. Under current law, however, the same taxpayer faces up to eight different rates for capital gains: 35%, 20%, 25%, 28%, 13.5%, 10.8%, 18%, and 0%. See *supra* note 340 and accompanying Table Four.

taxpayers will decrease.

Although the Joint Committee Report proposal is somewhat simpler for wealthier taxpayers, it represents a significant departure from current tax policy since a deduction or exclusion for all long-term capital gains has been absent from the Code for some fifteen years.<sup>356</sup> For example, significant policy implications cause the different tax rates for collectibles and unrecaptured depreciation deductions with respect to real property used in a trade or business activity. When all capital gains were subject to an exclusion, commentators argued that an equal preference for collectibles represented bad tax policy.<sup>357</sup> They argued that investments in collectibles were entirely speculative and were economically inefficient in that they restricted capital mobility and did not promote growth or employment. When Congress ultimately reduced the capital gains rate from 28% to 20%, it deliberately retained the 28% rate for collectibles in light of these criticisms.<sup>358</sup> The Joint Committee Report proposal, however, would restore the inequity that stirred commentators.

The need for a higher tax rate on depreciable real property is compelling. The Code permits taxpayers to depreciate the cost of real property used in a trade or business activity or held for investment.<sup>359</sup> The depreciation deductions offset ordinary income<sup>360</sup> and reduce the taxpayer's basis in the subject property.<sup>361</sup> When the taxpayer sells the real property, at least some portion of any resulting gain will be attributable to the prior depreciation deductions.<sup>362</sup> Yet the Code

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<sup>356</sup> See *supra* note 324. An exclusion of a portion of a capital gain is equivalent to a deduction in an amount equal to the same portion of the gain, assuming the deduction is available without limitation.

<sup>357</sup> See generally DANIEL POSIN, FEDERAL INCOME TAXATION OF INDIVIDUALS 264-65 (1983); Cynthia Blum, *Rollover: An Alternative Treatment of Capital Gains*, 41 TAX L. REV. 385, 422-27 (1986).

<sup>358</sup> See H.R. CONF. REP. NO. 105-220, at 382 (1997), *reprinted in* 1997 U.S.C.C.A.N. 678, 1194-95.

<sup>359</sup> I.R.C. § 167(a). Underlying land is not depreciable, but structures on land are depreciable. This is because depreciable property must be subject to "exhaustion" or "wear and tear." *Id.* The Modified Accelerated Cost Recovery System (MACRS) allows large deductions in the early years of an asset's useful life. For depreciation methods and operating rules, see section 168.

<sup>360</sup> I.R.C. §§ 161, 167(a).

<sup>361</sup> I.R.C. § 1016(a)(2).

<sup>362</sup> Suppose, for example, that a taxpayer purchased depreciable real property for \$936,000 and placed it in service on July 1, Year One. Ignoring any special elections, the taxpayer is entitled to claim an \$11,000 depreciation deduction in Year

provision requiring that portion of the gain to be taxed as ordinary income applies only when the taxpayer has used some form of accelerated depreciation,<sup>363</sup> which has been unavailable to taxpayers since 1986.<sup>364</sup> In other words, taxpayers using the ratable, straight-line depreciation method on such real property can still claim capital gain treatment in some cases.<sup>365</sup> To permit preferential tax treatment to a gain caused by the taxpayers taking a depreciation deduction to offset ordinary income is an unjustified double benefit.<sup>366</sup> The Joint Committee Report proposal would do just that since the gains from depreciable real property would receive the same treatment as all other capital gains.<sup>367</sup> The current system concedes a preferential rate but not one as great as the rate applied to most long-term capital gains. From a policy perspective, the current system is preferable to

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One and depreciation deductions of \$24,000 in Years Two through Thirty-Nine. See I.R.C. § 168(b)(3)(A), (d)(2), (d)(4)(B). Thus, at the end of Year Two, the taxpayer's adjusted basis in the property is \$901,000. See I.R.C. § 1016(a)(2). Now suppose the property has increased in value to \$1 million. If the taxpayer sells the property at the beginning of Year Three to an unrelated purchaser for \$1 million, only \$64,000 of the resulting gain represents real economic gain (the difference between the amount realized on the sale and the original purchase price of \$936,000). The rest of the gain, which in this case would be \$36,000, is attributable to the depreciation deductions in Years One, Two, and Three. There is a small depreciation deduction of \$1000 in Year Three because the Code requires the sale of the property described in this example to be treated for deduction purposes as if it were sold at the middle of the sale month. See I.R.C. § 168(d)(4)(B).

<sup>363</sup> I.R.C. § 1250(a).

<sup>364</sup> I.R.C. §§ 168(b)(3), 1250(b)(1).

<sup>365</sup> Although real property used in a trade or business activity is not a capital asset, I.R.C. § 1221(a)(2), gain from the sale of such property qualifies as "section 1231 gain" if the taxpayer held the property for more than one year. I.R.C. § 1231(b). If the taxpayer's "section 1231 gains" exceed the taxpayer's "section 1231 losses" for the taxable year, the gains and losses are treated as long-term capital gains and losses, meaning any net gain will qualify for preferential tax treatment. I.R.C. § 1231(a). If the subject real property is held as investment property, however, it is a capital asset to begin with, and the resulting gain is automatically eligible for the preferential tax rates if the subject property was held for more than one year. I.R.C. § 1221(a).

<sup>366</sup> Consider *supra* note 362. Ideally, \$36,000 of the \$100,000 realized gain should be treated as ordinary income because that is the portion of the gain that the taxpayer already recovered in the form of deductions against ordinary income. If the entire gain is treated as long-term capital gain, the taxpayer receives a double benefit.

<sup>367</sup> See 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 103 (Joint Comm. Print 2001).

the proposed deduction.<sup>368</sup>

The Joint Committee Report recommendation is a curious one because the Joint Committee staff deliberately refused to consider other simplification proposals that would alter the policy objectives of the subject Code provisions.<sup>369</sup> Since the proposal does not address the policy concerns that led to the multiple tax rates in the current system, Congress is unlikely to adopt the recommendation in its present form. If Congress did codify the proposal, however, one would expect that Congress would eventually tinker with the system to preserve higher tax rates for unrecaptured real property depreciation deductions and collectibles gains. At that point, the number of tax rates would grow even further, and from a simplification standpoint, the proposal is for naught.

There is another important objection to a deduction for capital gains. Professor John Lee observed that a capital gains exclusion – a functional equivalent of the Joint Committee Report deduction proposal<sup>370</sup> – unfairly benefits wealthier taxpayers and unfairly burdens poorer taxpayers.<sup>371</sup> Such a benefit occurs because capital gains of wealthy taxpayers usually represent real economic gain and not just inflation.<sup>372</sup> By excluding half of the gain, some real gain goes

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<sup>368</sup> Repealing the special depreciation recapture applicable to real estate in favor of applying the depreciation recapture rules currently limited to tangible personal property would be even simpler than the current system and might better achieve the recapture goal that is desired. But this idea warrants consideration because it might better serve the goal of recapture, not just because it is simpler.

<sup>369</sup> See *supra* note 319 and accompanying text.

<sup>370</sup> For individual taxpayers, an exclusion of half of the net capital gain from gross income is the functional equivalent of a deduction equal to 50% of the net capital gain so long as the deduction is used to compute adjusted gross income. That way, all individuals could claim an identical benefit. For example, if an individual has a net capital gain of \$10,000, a 50% exclusion would cause the taxpayer to include only \$5000 in gross income. Under the Joint Committee Report's deduction regime, the taxpayer would include the full \$10,000 gain but immediately deduct \$5000. In either case, only \$5000 of the gain is subject to taxation. The Joint Committee Report recommends that the proposed deduction be made available to all individuals no matter whether they itemize deductions or claim the standard deduction, so the proposed exclusion analyzed by Professor Lee is the equivalent of the Joint Committee Report's proposed deduction. See 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 103.

<sup>371</sup> John W. Lee, *Critique of Current Congressional Capital Gains Contentions*, 15 VA. TAX REV. 1, 4 (1995).

<sup>372</sup> *Id.* at 35-36.

untaxed. The capital gains of less affluent taxpayers, however, occur mostly due to inflation and not to real economic gain.<sup>373</sup> Excluding half of the gain still subjects poorer taxpayers to tax on inflation. Professor Lee believes that indexing a taxpayer's basis would be more equitable for poorer taxpayers, but he concedes that indexing is a poor proposal because wealthy taxpayers would have an added incentive to refrain from realizing gains.<sup>374</sup> He concludes that the current use of preferential rates is preferable to an exclusion or indexing system.<sup>375</sup> Under Professor Lee's analysis, the Joint Committee Report's proposal would prove to be an unjustified windfall to the wealthy and an unfair tax burden shift to the poor.

The current hybrid system is certainly complex, but the policy gains achieved under this hybrid system outweigh the benefits of simpler systems. The proposal will likely fall on deaf ears anyway, but in this case, that is a good result.

### C. *Income-Based Phaseouts and Phaseins*

The Code contains nearly twenty provisions that serve to limit tax benefits to taxpayers with certain income levels.<sup>376</sup> Recent estimates<sup>377</sup>

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<sup>373</sup> *Id.*

<sup>374</sup> *Id.* at 4.

<sup>375</sup> *Id.* For the argument that indexing a taxpayer's basis in assets for inflation is the superior result, see Arthur P. Hall, *Issues in the Indexation of Capital Gains*, 67 TAX NOTES 675 (1995); Reed Shuldiner, *Indexing the Tax Code*, 48 TAX L. REV. 537 (1993); Snoc, *supra* note 6, at 71-72.

<sup>376</sup> See I.R.C. §§ 21(a)(2) (limited phaseout of dependent care tax credit), 22(d) (partial phaseout of credit for elderly and disabled taxpayers), 23(b)(2) (phaseout of credit for adoption expenses), 24(b) (phaseout of per child tax credit), 25A(d) (phaseouts of both the Hope Scholarship Credit and the Lifetime Learning Credit), 32(b) (phasein and phaseout of earned income credit), 55(d)(3) (phaseout of AMT exemption amount for individual and corporate taxpayers), 68 (overall limitation on itemized deductions), 86 (phaseout of exclusion for social security and railroad retirement benefits), 135(b)(2) (phaseout of exclusion for interest from education savings bonds), 137(b) (phaseout of deduction for employer-provided qualified adoption expenses), 151(d)(3) (phaseout of personal and dependency exemptions), 219(g) (phaseouts of eligibility for deductible contributions to individual retirement account), 221(b)(2) (phaseout of deduction for student loan interest), 408A(c)(3) (phaseout of eligibility for Roth IRA and restriction on ability to convert IRA to Roth IRA), 469(i)(3) (phaseout of rental real estate offset from passive loss restrictions), 530(c) (phaseout of eligibility for education IRAs), 1400C(b) (phaseout of credit for first-time homebuyers in the District of Columbia).

<sup>377</sup> JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES, at 17 (Joint Comm. Print 1998).

claim that these so-called “phaseouts”<sup>378</sup> affect about one-fourth of all taxpayers. Phaseouts can significantly impact a taxpayer’s effective rate of taxation. Suppose, for example, that a married couple with two dependent children has an adjusted gross income<sup>379</sup> of \$250,000 and regular itemized deductions<sup>380</sup> of \$120,000 for the 2003 taxable year. Absent any phaseout provisions, the couple could claim two personal exemptions of \$3050<sup>381</sup> and two dependency exemptions of \$3050,<sup>382</sup> which would generate an additional deduction of \$12,200. Their taxable income would be \$117,800 (\$250,000 less \$132,200 in itemized deductions and personal exemptions), and their tentative federal income tax liability would be \$25,606.50.<sup>383</sup> The couple would also be entitled to total child tax credits of \$1200 (again assuming no phaseouts).<sup>384</sup> Assuming no other credits apply, the final income tax liability would be \$24,406.50. Note that the couple’s effective tax rate is only 9.76%.<sup>385</sup>

The couple in this simple example is, however, subject to three phaseouts that will increase the effective rate of tax. First, since their

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<sup>378</sup> Use of the term “phaseouts” is simplistic, of course, because some provisions are “phased-in” as a taxpayer’s income increases. See I.R.C. § 32(b) (phasein of earned income tax credit). In other cases, the tax benefit is not phased out but rather repealed immediately. See I.R.C. § 221(b)(2) (eliminating student loan interest deduction completely once “modified adjusted gross income” of unmarried taxpayer reaches \$65,000). Nonetheless, this article uses the term “phaseouts” to refer to phaseouts, phaseins, and immediate income-based limitations.

<sup>379</sup> For individuals, “adjusted gross income” means a taxpayer’s gross income less eighteen enumerated deductions. I.R.C. § 62(a). The concept of “adjusted gross income” is meaningless for corporations. See I.R.C. § 63(a), (b).

<sup>380</sup> A special phaseout applies to so-called “miscellaneous itemized deductions”: they are allowed only to the extent that they exceed 2% of the taxpayer’s adjusted gross income. I.R.C. § 67(a). All itemized deductions (those deductions not taken in computing adjusted gross income) that are not miscellaneous itemized deductions can be described as “regular itemized deductions.” The hypothetical example in the text assumes that all of the deductions are regular itemized deductions so as to avoid application of the section 67(a) phaseout provision. If the deductions in the text example were miscellaneous itemized deductions, a fourth phaseout would apply.

<sup>381</sup> See I.R.C. § 151(a); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.15(1).

<sup>382</sup> See I.R.C. § 151(c)(1); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.15(1).

<sup>383</sup> See I.R.C. § 1(a); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.01. The couple’s “marginal tax rate,” the tax rate applicable to the last dollar of taxable income, is 27%.

<sup>384</sup> See I.R.C. § 24(a).

<sup>385</sup> The effective rate of tax is determined by dividing the final tax liability, \$24,406.50, by the couple’s adjusted gross income, \$250,000.



adjusted gross income exceeds \$139,500,<sup>386</sup> their itemized deductions will be reduced to \$116,685.<sup>387</sup> Second, the exemption amount for the two taxpayers and the two children will decrease from \$3050 to \$2013.<sup>388</sup> Finally, since their adjusted gross income exceeds \$110,000, the child tax credit amount is reduced to zero.<sup>389</sup> As a result of these three phaseouts, taxable income increases to \$125,263,<sup>390</sup> and the final tax liability increases to \$27,845.40,<sup>391</sup> an effective tax rate of 11.14%.

Policymakers design phaseouts to enhance vertical equity.<sup>392</sup> As a

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<sup>386</sup> See I.R.C. § 68(b); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.10.

<sup>387</sup> See I.R.C. § 68(a). Three percent of the excess of adjusted gross income (\$200,000) over the threshold phaseout amount (\$139,500) is \$3315. This is less than 80% of total itemized deductions (\$120,000 x 80% = \$96,000), so the 3% reduction applies.

<sup>388</sup> See I.R.C. § 151(d)(3). The “threshold amount” under section 151(d)(3)(C) is adjusted for inflation. I.R.C. § 151(d)(4)(B). For 2003, the threshold amount for a married couple filing a joint return is \$209,250, the same threshold applicable to the overall limitation on itemized deductions. Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.15. In this example, adjusted gross income exceeds the threshold amount by \$40,750. \$40,750 divided by \$2500 is 16.3, and this number is rounded up to 17. See I.R.C. § 151(d)(3)(B). Seventeen times 2 percentage points equals 34 percentage points. Thus, the exemption amount is reduced by 34%, or \$1037. The exemption amount is therefore \$2013 (\$3050 minus \$1037).

<sup>389</sup> See I.R.C. § 24(b)(1)-(2). The statute refers to “modified adjusted gross income,” meaning adjusted gross income as computed without regard to certain deductions otherwise allowable in computing adjusted gross income. I.R.C. § 24(b)(1). The deductions in this case are those authorized under sections 911 (foreign earned income and housing costs of U.S. citizens and residents living abroad), 931 (income attributable to sources or activities in Guam, American Samoa, or the Northern Mariana Islands), and 933 (income attributable to sources or activities in Puerto Rico). *Id.*; see also I.R.C. §§ 911, 931, 933. Assuming, then, that none of these deductions applies in this example, “modified adjusted gross income” (\$250,000) exceeds the applicable threshold amount (\$110,000) by \$140,000. \$140,000 divided by \$1000 equals 140, and 140 times \$50 is \$7000. Thus, the amount of the per child tax credit is supposed to be reduced by \$7000. Since the credit amount is only \$600 per child, of course, the adjustment serves to eliminate the credit entirely.

<sup>390</sup> Taxable income is the excess of adjusted gross income (\$250,000) over allowable deductions (\$116,685) and personal and dependency exemptions (\$8052, or 4 times \$2013). See I.R.C. § 63(a).

<sup>391</sup> See I.R.C. § 1(a); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.01.

<sup>392</sup> Charles S. Hartman, *Missed It By That Much: Phase-out Provisions in the Internal Revenue Code*, 22 U. DAYTON L. REV. 187, 192-93 (1996). With regard to the section 68 limitation on itemized deductions, for example, the legislative history merely states that the provision is intended to limit itemized deductions and makes no reference to vertical equity or progressivity. H.R. CONF. REP. NO. 101-964, at 1030-33 (1990). But commentators at the time observed that enhanced progressivity was indeed in the minds of many legislators when section 68 was enacted in 1990.

result of phaseouts, marginal tax rates for the wealthiest taxpayers can exceed 40%,<sup>393</sup> while the maximum statutory marginal rate – the rate that taxpayers see in the tax tables – is only 38.6%.<sup>394</sup> It is politically unappealing for Congress to increase tax rates, and the use of phaseouts allows Congress to reduce marginal tax rates while generating equivalent revenues.<sup>395</sup> In addition, phaseouts can reduce the revenue loss from a tax benefit because the benefit is limited to lower-income taxpayers, thus increasing the efficiency of the federal income tax.

Despite these advantages, the Joint Committee Report recommends the repeal of several phaseout provisions (including the three described in the above example) on the grounds of complexity.<sup>396</sup> The phaseouts targeted for repeal contribute to a

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*See, e.g.,* J. Andrew Hoerner, “Pease Plan” Emerges as Key Issue in Debate Over Tax Progressivity, 49 TAX NOTES 498, 498-99 (Oct. 29, 1990); Gene Steuerle, *Budget Act 1990: Revival of the Progressivity Debate*, 49 TAX NOTES 1251, 1252 (Dec. 10, 1990). For more on the virtues of vertical equity, see *infra* Part V.A.

<sup>393</sup> See JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 4-9 (Joint Comm. Print 1998). Suppose, for example, that an unmarried taxpayer has an adjusted gross income in 2003 of \$400,000 and otherwise allowable regular itemized deductions of \$50,000. Because the taxpayer’s adjusted gross income exceeds \$139,500, the total itemized deductions will be reduced to \$42,185. See I.R.C. § 68; see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.10. Further, the taxpayer’s \$3050 personal exemption is completely phased out. See I.R.C. § 151(d); see also Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.15(2). Thus, the taxpayer’s taxable income is \$357,815, placing the taxpayer in the highest marginal tax bracket (38.6%). If the taxpayer in this example earns an additional \$1000 in 2003, the taxpayer’s itemized deductions will be reduced by another \$30, increasing taxable income from \$357,815 to \$358,845. The extra \$1030 of taxable income will be taxed at 38.6%, resulting in additional tax of \$397.58. Thus, the marginal rate of tax on the last \$1000 of gross income is really 39.758%. The section 68 phaseout alone increased the marginal rate by more than 1%. If the taxpayer in this example was subject to additional phaseouts, it is easy to see how the marginal tax rate can increase to above 40%.

<sup>394</sup> I.R.C. § 1(i)(2).

<sup>395</sup> Professor Peroni describes the section 68 phaseout of itemized deductions and the section 151(d)(3) phaseout of the personal exemption deduction as “gimmicks” for increasing tax rates without explicitly increasing the rates in the statutory tax tables. Robert J. Peroni, *Reform in the Use of Phase-Outs and Floors in the Individual Income Tax System*, 92 TAX NOTES 1415, 1433-34 (Special Supp., May 28, 2001).

<sup>396</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 88 (Joint Comm. Print 2001). The phaseouts subject to the recommendation for repeal are the overall limitation on itemized deductions (I.R.C. § 68), the phaseout of

taxpayer's compliance burden because they require taxpayers to locate and complete additional worksheets, perform more calculations, and compute special figures like "modified adjusted gross income."<sup>397</sup> The Joint Committee Report also concludes that these phaseouts impede the ability of taxpayers to take advantage of tax benefits intended for them.<sup>398</sup> It offers the following illustration:

For example, a taxpayer who files as a head of household with \$40,000 of income and has a child in the first year of college would be eligible for a HOPE credit of up to \$1,500. However, if the taxpayer recognized a \$10,000 capital gain to pay tuition, the taxpayer would no longer be eligible for the credit. The well-advised taxpayer who needed the funds to pay tuition might be able to avoid such a result by doing the capital gain transaction in a tax year prior to the year tuition will be paid.<sup>399</sup>

Finally, the Joint Committee Report states that the phaseouts make it difficult for taxpayers to estimate their total tax liability, which can cause taxpayers subject to estimated tax payments to face penalties.<sup>400</sup>

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personal and dependency exemptions (I.R.C. § 151(d)(3)), the phaseout of the child tax credit (I.R.C. § 24(b)), the limited phaseout of the dependent care tax credit (I.R.C. § 21(a)(2)), all phaseouts related to IRAs (I.R.C. §§ 219(g), 408A(c)(3), 530(c)), the phaseout of the Hope Scholarship Credit and the Lifetime Learning Credit (I.R.C. § 25A(d)), the phaseout of the deduction for student loan interest (I.R.C. § 221(b)(2)), the phaseout of the exclusion for interest on education savings bonds (I.R.C. § 135(b)(2)), and the phaseout of the adoption credit and the exclusion for employer-provided qualified adoption expenses (I.R.C. §§ 23(b)(2), 137(b)). *Id.*

With respect to the other phaseout provisions, the Joint Committee Staff does not advocate repeal because "these phase-outs serve purposes other than, or in addition to, achieving progressivity." *Id.* at 89 n.137.

<sup>397</sup> *Id.* at 87.

<sup>398</sup> *Id.* at 88; see also Reed Shuldiner & David Shakow, *Lessons from the Limitation on Itemized Deductions*, 93 TAX NOTES 673, 689-92, 694 (Oct. 29, 2001) (proving that the section 68 overall limitation on itemized deductions causes 5% of taxpayers with adjusted gross incomes between \$500,000 and \$1 million to claim the standard deduction).

<sup>399</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 88.

<sup>400</sup> *Id.* Under section 6654, an underpayment of estimated taxes results in an addition to tax computed by applying the interest rate prescribed in section 6621 for underpayments of tax. I.R.C. § 6654. The penalty does not apply if the total tax due (after application of the credit for income tax withheld in section 31) is less than \$1000 or if the taxpayer had no income tax liability for the prior taxable year,

Some commentators contend that phaseouts enhance simplicity because high-income taxpayers subject to the phaseouts can dispense with the recordkeeping requirements associated with such benefits.<sup>401</sup> Even if phaseouts contribute to tax complexity, the result is acceptable considering the extent to which phaseouts enhance vertical equity.<sup>402</sup> Further, reform can mitigate the alleged complexities cited by the Joint Committee Report – repeal is another over-correction.<sup>403</sup> Conforming many phaseouts to the same thresholds and computations can simplify to some extent the many computations facing wealthy taxpayers subject to multiple phaseouts. With little sacrifice of revenue, Congress could adopt unifying definitions of “modified adjusted gross income” or other terms commonly used in phaseout computations.<sup>404</sup> Consistent definitions would do a lot to

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assuming that year lasted for twelve months and the taxpayer is a U.S. citizen or resident. I.R.C. § 6654(e)(1)-(2). Most taxpayers are not required to pay estimated taxes because the income tax withheld on wages is treated as an automatic payment of estimated taxes. I.R.C. § 6654(g)(1). Thus, estimated tax penalties apply mostly to taxpayers without wages and to those taxpayers with significant income from other sources on which estimated taxes were not paid.

<sup>401</sup> See Pollack, *supra* note 4, at 356-57; see also C. EUGENE STEUERLE, THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA 136-37 (1992).

<sup>402</sup> [T]he attempt merely to create a statutory definition of economic net income contributes complexity to the income tax. Given the tremendous complexity involved in trying to achieve a fair measure of net income, the complexity attributable to progressivity seems minor. Add to this the many tax expenditures accomplished through deductions, and the complexity from brackets is barely visible.

Byrne, *supra* note 29, at 748-49.

<sup>403</sup> Nevertheless, the 2001 Act calls for the gradual repeal of the overall limitation on itemized deductions. I.R.C. § 68(f). Beginning in 2006, taxpayers must reduce the total amount of itemized deductions by only two-thirds of the amount required under current law. *Id.* In 2008, taxpayers only have to reduce the total amount of itemized deductions by one-third of the amount required under current law. *Id.* Finally, as of 2010, the overall limitation on itemized deductions is fully repealed. I.R.C. § 68(g). In other words, Congress has decided to phaseout one of the major phaseouts.

<sup>404</sup> There are several different meanings for the term “modified adjusted gross income.” For purposes of the child tax credit and the Hope Scholarship and Lifetime Learning Credits, the term means adjusted gross income plus amounts deducted for certain foreign income. I.R.C. §§ 24(b)(1), 25A(d)(3). For a more detailed description of modified adjusted gross income for purposes of the child tax credit, see *supra* note 389. With respect to the earned income credit, however, modified adjusted gross income means adjusted gross income plus amounts allowed as a deduction under four other Code sections plus amounts excluded under two other Code sections. I.R.C. § 32(c)(5). And for purposes of computing the amount of

reduce the tax complexity of phaseouts.

Some have argued that phaseouts have problems beyond complexity. One common argument is that phaseouts impede efficiency by distorting taxpayer choices, but this argument is based on unproven theoretical assertions. One such assertion is that phaseouts may affect a taxpayer's decision to work. For example,<sup>405</sup> suppose an unmarried taxpayer has an adjusted gross income of \$139,500 in 2003, the highest adjusted gross income possible without application of the personal exemption phaseout.<sup>406</sup> Now suppose that the taxpayer has the opportunity to accept additional work that will increase the taxpayer's adjusted gross income by \$3000. The extra income serves to increase the taxpayer's tax liability by \$937, \$900 from the additional tax attributable to the extra \$3000 of income<sup>407</sup> plus \$37 due to the applicability of the personal exemption phaseout.<sup>408</sup> The net benefit of taking on the additional work is \$2063 (\$3000 less the \$937 in additional tax). The taxpayer may conclude that the extra work and the opportunity cost of lost relaxation are not worth \$2063 so the taxpayer may choose to forego the additional work. If so, the argument goes, society loses the benefit of the taxpayer's extra labor. As the example shows, the additional cost attributable to the phaseout will always be minor compared to that portion attributable to application of the taxpayer's statutory marginal rate.<sup>409</sup> Further, some studies question the effect of marginal

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Social Security benefits included in gross income, modified adjusted gross income means adjusted gross income computed without regard to three exclusion provisions and five deduction provisions. I.R.C. § 86(b)(2). Other phaseouts also use the term. See I.R.C. §§ 135 (education savings bonds), 221 (student loan interest deduction), 408A (Roth IRAs), 1400C (District of Columbia first-time homebuyer credit).

<sup>405</sup> This example is loosely modeled after the one set forth in JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 94 (Joint Comm. Print 1998).

<sup>406</sup> See Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.15(2).

<sup>407</sup> The taxpayer in this example is in the 30% rate bracket for 2003. See *id.* § 3.01; see also I.R.C. § 1(i). Thus the extra tax created by an additional \$3000 in taxable income is \$900.

<sup>408</sup> The exemption amount for 2003 is \$3050. See *supra* notes 381-82 and accompanying text. The personal exemption phaseout requires the taxpayer in this example to reduce the exemption amount by 4%, or \$122. See I.R.C. § 151(d). For more detail on the computation of the reduction, see *supra* note 388 and accompanying text. Before the phaseout, the taxpayer could deduct the \$122 amount, and the tax attributable to that amount is, after rounding, \$37 (30% of \$122 is \$36.60). Thus the tax liability is increased by \$37 because of the phaseout.

<sup>409</sup> The Joint Committee has concluded that the personal exemption phaseout only increases the effective marginal tax rate by 2.16% for each exemption claimed.

tax rates on incentives to work.<sup>410</sup>

A second assertion is that taxpayers may alter timing decisions due to phaseouts.<sup>411</sup> In the head of household example excerpted above from the Joint Committee Report,<sup>412</sup> the taxpayer has an incentive to recognize a capital gain in an earlier year to avoid the Hope Scholarship Credit and/or Lifetime Learning Credit phaseouts. Incentives to recognize gains earlier, however, are efficient for the government. In other cases, taxpayers may choose to defer gains or other forms of income to avoid a phaseout. If Congress eliminated phaseouts from the Code, taxpayers will still consider timing in structuring transactions. Repeal of phaseouts will not change this inefficient behavior.

Another common argument is that phaseouts violate horizontal equity, but this argument too is flawed. In another report, the Joint Committee staff explained that phaseouts generally do not affect horizontal equity:

For example, two married couples may have identical modified [adjusted gross incomes] of \$85,000, the same number of children, and other identical economic characteristics. However, if the Smith family has a daughter in college while the Jones family daughter forgoes college, the Smiths and the Jones will have different Federal income tax liabilities. The Smiths will be able to claim a tax credit for a portion of their daughter's college expenses. The Jones family will not. The Smiths will have a smaller tax burden. However, the family income of \$85,000 puts the Smith family in the phase-out range for the HOPE or Lifetime Learning credits, so the Smith family will have an effective marginal tax rate greater than that of the Jones family, but will be able to claim some education credits against their income tax

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JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 5; *see also supra* note 393. Only in the case of very large families could the added tax from the phaseout meaningfully affect a taxpayer's decision whether to perform additional work.

<sup>410</sup> *See, e.g.*, CONGRESSIONAL BUDGET OFFICE, FOR BETTER OR FOR WORSE: MARRIAGE AND THE FEDERAL INCOME TAX 10-12 (1997); Charles L. Ballard et al., *General Equilibrium Computations of the Marginal Welfare Costs of Taxes in the United States*, 75 AM. ECON. REV. 128 (1985); Robert K. Triest, *The Effect of Income Taxation on Labor Supply in the United States*, 25 J. HUM. RESOURCES 491 (1990).

<sup>411</sup> *See, e.g.*, JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 96.

<sup>412</sup> *See supra* note 399 and accompanying text.

liability. Some observers find it unfair that the Smith family has a higher effective marginal tax rate than does the Jones family, but, in fact, the Smith family has the lower aggregate tax burden. Other observers would find it unfair that the Jones family has a higher aggregate tax burden because they are not treated equally to the Smiths. This would appear to violate the concept of horizontal equity. However, the apparent horizontal inequity is not created by the phase-out provision. If, in the example above, Smith and Jones had each had incomes of \$60,000, beneath the phase-out range, it would remain the case that Smith's tax liability is less than Jones's by reason of the credit.

One rationale for creating the education credits was a belief that the burdens of paying for a college education imply that two families cannot be considered to be similarly situated if, though all else is equal, one is paying college expenses while the other is not. Advocates of this position would aver that horizontal equity is not violated. They would note that the education credits apply equally in the sense of horizontal equity to all taxpayers incurring college education expenses.<sup>413</sup>

Whether any Code provision violates horizontal equity is a question of scope.<sup>414</sup> From a very broad perspective, the Smith and Jones families in the quoted excerpt appear to receive different treatment despite their many similarities. Upon closer examination, there are differences between the two families – one is paying for higher education and the other is not. In Congress' eyes, that distinction makes the two families sufficiently dissimilar so that disparate tax treatment in the form of an education credit does not violate horizontal equity. If one maintains that the education credit violates horizontal equity, however, then one should also recall the other important point made by the Joint Committee staff in the above excerpt: the phaseout provision does not cause the inequity – the underlying credit does. At most, phaseouts only slightly compound pre-existing horizontal equity violations.

The Joint Committee Report recommendation for repeal of certain phaseouts has merit, but not because of cries for

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<sup>413</sup> JOINT COMM. ON TAXATION, 105TH CONG., PRESENT LAW AND ANALYSIS RELATING TO INDIVIDUAL EFFECTIVE MARGINAL TAX RATES 98-99 (footnote omitted).

<sup>414</sup> See Byrne, *supra* note 29, at 759-63.

simplification. Congress should eliminate phaseouts when they contravene their intended purpose. While phaseouts generally do enhance the progressivity of the federal income tax, phaseouts also make the tax rates more regressive for some taxpayers. For example, assume that Taxpayer A has an adjusted gross income of \$350,000 and otherwise allowable itemized deductions of \$25,000 for the taxable year ending in 2003. Ignoring personal exemptions, A's taxable income for 2003 would normally be \$325,000. Since A's adjusted gross income exceeds the \$139,500 "applicable amount" under section 68,<sup>415</sup> A must reduce A's total itemized deductions by 3% of the \$210,500 excess, or \$6315.<sup>416</sup> Thus, A's itemized deductions would decrease to \$18,685. If A earned an additional \$100 of income, the section 68 phaseout would require A to reduce A's itemized deduction by another \$3.<sup>417</sup> Since the additional tax on the \$103 of taxable income would be \$39.76, the phaseout actually increases A's marginal rate of tax by 1.16%.<sup>418</sup>

In comparison, suppose that Taxpayer B has an adjusted gross income of \$1,000,000 and otherwise allowable itemized deductions of \$25,000 for the taxable year ending in 2003. Since B's adjusted gross income exceeds the "applicable amount" by \$860,500, B might have to reduce B's itemized deductions by \$25,815 (3% of the \$860,500 excess over the "applicable amount"). The maximum possible reduction to B's itemized deductions is \$20,000, 80% of the otherwise allowable total.<sup>419</sup> If B earns an extra \$100 of income, therefore, there is no further reduction to B's itemized deductions, meaning that B's marginal rate of tax on that extra \$100 (capped at 38.6%) will be less than A's marginal rate of tax on the extra \$100 (39.76%). The 80% cap on the reduction provided in section 68 detracts from the progressivity intended by the phaseout. These marginal tax rate "bubbles" are inappropriate because the marginal tax rate should never decrease as taxable income increases.

Due to these bubbles, the Joint Committee Report's recommendation deserves consideration. Repealing the section 68

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<sup>415</sup> See I.R.C. § 68(b); *see also* Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.10.

<sup>416</sup> See I.R.C. § 68(a); *see also* I.R.C. § 68(b); Rev. Proc. 2002-70, 2002-46 I.R.B. 845, § 3.10; *supra* note 387 and accompanying text.

<sup>417</sup> See *supra* note 393.

<sup>418</sup> Taxpayer A is in the 38.6% maximum rate bracket. The tax on \$103 at this rate is \$39.76. That represents 39.76% of the \$100 additional income that A earned. The 39.76% marginal tax rate on the \$100 of additional income is 1.16% higher than the 38.6% marginal rate found in the statute.

<sup>419</sup> See I.R.C. § 68(a).



phaseout and similar provisions solely in the name of simplicity is a mistake. Other commentators are offended at the backhanded or tricky way in which phaseouts enhance vertical equity.<sup>420</sup> Congress appears deceitful when it announces an across-the-board “tax cut” and simultaneously adds income-based phaseouts to the Code, as it did with the Tax Reform Act of 1986.<sup>421</sup> In an ideal world, Congress would have the courage to confess to taxpayers that it will limit certain tax benefits in the hands of wealthy taxpayers and that, as a result, the effective marginal rates of wealthier taxpayers may exceed the applicable marginal tax rate stated in the tax tables. Ultimately, however, phaseouts can be an effective means to enhance vertical equity at a relatively low revenue cost.

## V. SIMPLICITY AS A TAX POLICY OBJECTIVE

Of the three traditional criteria for evaluating a tax<sup>422</sup> – equity, efficiency, and simplicity – the latter is the hardest to define and the hardest to apply with any meaningful precision.<sup>423</sup> Scholars basically agree that an income tax is equitable when it imposes the same tax liability on two persons with equal incomes (horizontal equity)<sup>424</sup> and when the tax liabilities of persons with higher incomes exceed the tax liabilities of persons with lower incomes (vertical equity).<sup>425</sup> They also generally agree that an income tax is efficient if it raises substantial revenues at relatively low costs to taxpayers and the government,<sup>426</sup> and some believe that efficiency increases if the income tax has little or no effect on taxpayer decisions.<sup>427</sup> No consensus exists as to what makes a tax simple. To determine whether simplicity is a legitimate

<sup>420</sup> See, e.g., Calvin H. Johnson, *Simplification: Replacement of the Section 68 Limitation on Itemized Deductions*, 78 TAX NOTES 89 (Jan. 5, 1998); Peroni, *supra* note 395, at 1433-34; Shuldiner & Shakow, *supra* note 398, at 674.

<sup>421</sup> See Tax Reform Act of 1986, Pub. L. No. 99-514, §§ 101, 501, 701, 1122, 1201, 100 Stat. 2085.

<sup>422</sup> See Sneed, *supra* note 29.

<sup>423</sup> See Bittker, *supra* note 23, at 1; see also McCaffery, *supra* note 5, at 1269.

<sup>424</sup> See MICHAEL J. GRAETZ & DEBORAH H. SCHENK, FEDERAL INCOME TAXATION: PRINCIPLES AND POLICIES 25-26 (4th ed. 2001).

<sup>425</sup> *Id.* at 30-33.

<sup>426</sup> See Kornhauser, *supra* note 61, at 483-85; see also Zelinsky, *supra* note 32, at 978-1012; *infra* Part V.C.

<sup>427</sup> See, e.g., GRAETZ & SCHENK, *supra* note 424, at 26-27; Butler, *supra* note 29, at 72-73; Shimon B. Edelstein, Note, *Indexing Capital Gains for Inflation: The Impacts of Recent Inflation Trends, Mutual Fund Financial Intermediation, and Information Technology*, 65 BROOK. L. REV. 783, 787 (1999). See also *infra* Part V.C.

criterion for evaluating a tax, one must at least attempt to define the term.

### A. Defining Simplicity and the Unique Impact of Tax Complexity

In defining simplicity, one might start by defining its opposite – complexity.<sup>428</sup> The federal tax laws are “complex” because: (1) they contain a large number of rules;<sup>429</sup> (2) those several rules are highly detailed;<sup>430</sup> (3) they relate to concepts that are difficult to reduce to rules;<sup>431</sup> (4) they reflect many principles, some of which may conflict;<sup>432</sup> (5) they require technical expertise to comprehend fully;<sup>433</sup> (6) they

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<sup>428</sup> Other commentators categorize different types of tax complexity. *See, e.g.*, DAVID BRADFORD, UNTANGLING THE INCOME TAX 266-67 (1986) (describing “compliance complexity” as the burden imposed in keeping required records and completing required forms, “transactional complexity” as the extra measures one undergoes solely to minimize taxes, and “rule complexity” as the difficulty in understanding and applying the law); McCaffery, *supra* note 5, at 1270-72 (distinguishing “technical complexity,” the understandability of a law in isolation; “structural complexity,” the conduciveness of the law to tax planning; and “compliance complexity,” the recordkeeping burden imposed by the law); Paul, *supra* note 63, at 157-63 (describing tax complexity in terms of “complication,” the number and detail of authorities; “intractability,” referring to the fact that an income tax relies upon concepts difficult to apply; and “incoherence,” the complexity resulting when the tax laws embody inconsistent purposes); Joel Slemrod, *Optimal Tax Simplification: Toward a Framework for Analysis*, in PROCEEDINGS OF THE SEVENTY-SIXTH ANNUAL CONFERENCE ON TAXATION (1984) (distinguishing only between “compliance costs” to taxpayers and “administrative costs” to the government). This article refrains from making similar distinctions, for as Professor Miller said, “[a]ny attempt to characterize or categorize tax complexity is likely to be fundamentally arbitrary.” Miller, *supra* note 76, at 12. But Miller himself ultimately identifies two types of tax complexity – “elaborative complexity” (the amount of material that must be absorbed to answer a tax question) and “judgmental complexity” (the “intellectual, moral and philosophical burdens a tax question may pose for one who has mastered the rules”). *Id.*

<sup>429</sup> *See supra* note 7 and accompanying text.

<sup>430</sup> *See supra* Parts II.A.4, II.B.1.

<sup>431</sup> Paul, *supra* note 63, at 159-61 (noting the “intractability” of the Code because of its reliance on difficult concepts like “realization,” “dividend,” and “business purpose”); *see also supra* Part II.A.6.

<sup>432</sup> Paul, *supra* note 63, at 161-63 (noting inconsistencies such as exemptions for imputed income, gifts, and unrealized appreciation from the comprehensive gross income base and the different treatment of various savings mechanisms like retirement plans versus ordinary interest-bearing bank accounts); *see also supra* Parts II.A.1, II.C.1.

<sup>433</sup> *See generally supra* Part II.B.1.

frequently change;<sup>434</sup> and (7) several decision-making institutions, each with distinct authority, apply them.<sup>435</sup> These same qualities could describe nearly every body of law.<sup>436</sup> The federal bankruptcy laws, for example, are similar in that they consist chiefly of intricately detailed statutes,<sup>437</sup> which, as a practical matter, require nearly all persons facing bankruptcy to retain specialized counsel. There is even a special federal court for bankruptcy matters,<sup>438</sup> as there is the United States Tax Court for taxation matters.

Complexity is not unique to those areas of the law based primarily on statutes, like taxation and bankruptcy. Tort law is also complex. Again, the average plaintiff or defendant needs the advice of counsel to navigate through the substantive law, leaving aside the procedural rules that will govern the process of dispute resolution. Although there are few federal tort law statutes,<sup>439</sup> there is the functional equivalent in the Restatement of Torts. Like taxation, tort law is constantly evolving, as plaintiffs advance new theories for recovery and defendants offer new theories for defenses.

<sup>434</sup> See *supra* Part II.A.2.

<sup>435</sup> Binding tax authority can come from Congress (the Code and tax treaties), the Treasury Department (regulations), the Internal Revenue Service (private rulings and revenue rulings), and the courts (including the specialized United States Tax Court).

<sup>436</sup> Miller, *supra* note 76, at 50-54; see also Zygmunt J.B. Plater, *Environmental Law and Three Economies: Navigating a Sprawling Field of Study, Practice, and Societal Governance in Which Everything is Connected to Everything Else*, 23 HARV. ENVTL. L. REV. 359 n. 7.

Environmental law is now technically more voluminous than tax law. The Internal Revenue Code and its regulations add up to something on the order of 6000 pages. The cumulative statute and regulatory pages for just three of the major federal regulatory statutes – the CWA, the CAA, and the RCRA – total more than 11,546 pages.

*Id.*

<sup>437</sup> Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1330 (2003).

<sup>438</sup> A bankruptcy case brought to a federal district court is automatically referred to the United States Bankruptcy Court for the district. 28 U.S.C. § 1334(a) (2003). Bankruptcy judges serve fourteen-year terms and are appointed by the United States Court of Appeals having jurisdiction over the district. 28 U.S.C. § 152(a)(1) (2003). For a general overview of the structure and function of the bankruptcy courts, see ROBERT L. JORDAN ET AL., *BANKRUPTCY* 823-85 (5th ed. 1999).

<sup>439</sup> See, e.g., 18 U.S.C. § 2510-2522 (federal action for telephone tapping); 42 U.S.C. § 1983 (federal tort action against anyone who under color of state law deprives another of a federally secured right); 45 U.S.C. §§ 1-23 (repealed 1994) (Federal Safety Appliance Act); 45 U.S.C. §§ 51-60 (Federal Employers' Liability Act).

Where are the voluminous cries for simplification of tort laws? Where are the demands for bankruptcy laws that “normal” people can understand? In this regard, tax complexity is unique – it seems to be the legal field with the most enemies. The popular sentiment against tax complexity is hardly surprising when one considers three unique aspects of the federal tax laws. First and foremost, taxation affects more people than other areas of law. Fewer individuals encounter tort laws because they are less likely to be plaintiffs or defendants in a tort action than they are to be taxpayers. Even fewer people ever come into contact with the federal bankruptcy laws. However, more than 125 million individuals file federal income tax returns every year.<sup>440</sup> Even those wage-earners who do not file returns still sense the effect of taxation because of tax withholding.<sup>441</sup> Of course, the vast majority of taxpayers have never read any provisions of the Code. Their experience involves only the individual income tax return and the corresponding set of instructions. In the forms and instructions, taxpayers encounter the tax laws directly. Moreover, the requirement to file an income tax return forces most individuals to interact with the federal tax laws. Individuals come into contact with other areas of the law only by choice. The only choice involved in federal income tax laws is the choice to earn income – hardly an option. Since taxation regularly interjects itself into the lives of millions, more individuals will have opinions about tax complexity than they will about antitrust complexity, securities complexity, or even tort complexity.

Second, unlike virtually every other area of the law, the tax laws rely upon taxpayers to police themselves. There is no federal tax collector who knocks on the doors of taxpayers on April 15 demanding tribute (and maybe a convenience charge). Instead,

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<sup>440</sup> For 1998, a total of 124,770,662 individual income tax returns were filed. David Campbell et al., 20 STAT. INCOME BULL. 8, 26, tbl.1 (2001). This represented an increase of 1.9% over returns for 1997. *Id.* at 8. The data from the 1998 returns does not indicate how many of these returns were joint returns filed by husband and wife, but one would think that a very substantial portion of the total returns were filed by two taxpayers. Thus the figure of 125 million expressed in the text is very conservative.

<sup>441</sup> Sections 3401-3404 generally require employers to withhold prescribed amounts from an employee’s “wages” and to remit such taxes directly to the federal government. I.R.C. §§ 3401-3404. Employees then credit amounts withheld against the federal income tax liability associated with their taxable incomes. I.R.C. § 31. For a general discussion of the meaning of “wages” and the many exceptions to the withholding rules, see BITTKER ET AL., *supra* note 35, ¶ 44.4[2].

taxpayers begin the assessment process by filing a return<sup>442</sup> and either paying additional tax, claiming a refund, or showing that any tax already withheld exactly matches the amount the taxpayer owes. Voluntary assessment is one of the signature features of our federal income tax, but it also fuels the calls for simplification. The federal tax laws require individuals to assess their own annual tax liability, but we do not provide sufficient technical training that allows all taxpayers to feel at ease in complying with the tax forms and instructions. Some high schools may teach students how to complete a Form 1040-EZ, the short form for wage earners with very little investment income, but this education is both non-uniform and incomplete. Accordingly, most taxpayers feel ill-equipped to tackle a daunting, two-page tax form with forty or more lines and instructions that exceed seventy pages. This experience is inevitable in any system where self-assessment is the paradigm for enforcement.

Much of the furor over tax complexity would disappear if the federal government computed each taxpayer's annual liability and sent either a bill or a refund.<sup>443</sup> Of course, there would still be disputes between taxpayers and the government over the amount of a bill or refund (as there are now), but individuals would not have to be involved in the computation of tax liability unless they chose to dispute the amount of tax paid. While the elimination of self-assessment would do much to calm the storm surrounding tax complexity, it is not a viable option. Voluntary assessment invites participation in the taxation process. By letting taxpayers make the initial determination of tax liability, the government accords them dignity. It also fosters some sense of trust; taxpayers would likely be suspicious of a post card notifying them of tax liability without some evidence of the computations supporting the final determination. Finally, voluntary assessment is more cost-efficient for the government than government assessment. By making a tax return a statement subject to perjury and other penalties,<sup>444</sup> the government can generally rely upon the information supplied by a taxpayer. The government need not incur the expense required to obtain the information from or about the taxpayer. The taxpayer must incur costs to obtain, assemble, and report the information required to

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<sup>442</sup> See generally I.R.C. § 6011(a).

<sup>443</sup> Gale, *supra* note 9, at 1471 (noting that thirty-six countries already use a comparable system of billing taxpayers instead of relying on self-assessment).

<sup>444</sup> See, e.g., I.R.C. §§ 6065 (requirement that all documents required to be filed under federal tax laws must contain declaration that they are made under penalties of perjury), 6662 (accuracy-related penalty), 6663 (fraud penalty).

complete the tax return, but generally the cost to the taxpayer will be less than the cost would be to the government because the taxpayer already has access to much of the information required to complete the return. Voluntary assessment is a highly desirable characteristic of our tax system. The price of greater confusion among the public is acceptable.

Third, the federal tax laws are an unusual amalgamation of laws designed to serve mutually exclusive objectives. Congress designed some tax laws to have little or no effect on taxpayer behavior. For example, the Code defines gross income as "all income from whatever source derived."<sup>445</sup> By using this broad definition, which (not coincidentally) matches the definition supplied in the Sixteenth Amendment,<sup>446</sup> the Code gives no ostensible preference for the means by which taxpayers derive income. In other words, there is no incentive for an individual to produce income from one type of employment activity over another. Consequently, taxation is not a criterion for choosing one's career path. The tax expenditure provisions in the Code instead influence taxpayer behavior in a way that produces some positive externality.<sup>447</sup> Congress, in its wisdom, grants a deduction for home mortgage interest so that taxpayers have an incentive to own (rather than to rent) a home.<sup>448</sup> If more taxpayers own homes, more individuals will build homes, more individuals will work as real estate brokers, and more individuals will work for title and insurance companies. By foregoing the revenues attributable to the mortgage interest deduction, Congress hopes to maintain its overall revenue base through steady employment and high consumption rates.

The impact of tax expenditures on the uniqueness of tax complexity is undeniable. Tax expenditures routinely violate basic principles of the federal income tax. This breeds confusion among

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<sup>445</sup> I.R.C. § 61(a).

<sup>446</sup> U.S. CONST. amend. XVI.

<sup>447</sup> For more on tax expenditures and their effect on tax complexity, see *supra* Part II.A.1.

<sup>448</sup> See JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 263-64 (Joint Comm. Print 1987). Under prior law, the Code allowed individuals a deduction for all interest paid during the taxable year, regardless of whether the related debt was associated with a business, investment, or personal activity or expenditure. When Congress limited the interest deduction only to debts associated with business activities or expenditures or, to a lesser extent, investment activities or expenditures, the deduction for home mortgage interest was retained. *Id.*

taxpayers. An individual, for instance, might know of the home mortgage interest deduction and reasonably extrapolate from this rule that all home-related expenses are deductible. Of course, this extrapolation is wrong, but the mortgage interest deduction reasonably leads taxpayers into thinking other, related expenditures may be deductible. Some taxpayers will likely claim such deductions without checking for authority. Those that do check, however, soon realize that their instinct is wrong. In their case, they will perceive that the Code lacks any coherent principles because the exception to the rule (the mortgage interest deduction) was their starting point. In other areas of the law, general principles are easier to discern.

Thus, tax complexity is probably not much more difficult, if at all, than tort complexity, bankruptcy complexity, securities complexity, or antitrust complexity, to name but a few. Unlike other fields, tax complexity affects most persons directly, it relies on voluntary compliance, and its general principles are harder to discern than those in other fields. For these reasons, tax complexity is at the forefront of the simplification debate.

If we define tax complexity as that pervasively unique combination of features previously identified, a workable definition of simplicity is possible. With respect to the federal tax laws, simplicity measures the extent to which a rule: (1) reduces the number of other rules, (2) reduces the overall degree of detail, (3) reduces concepts to workable rules, (4) reduces conflict among two or more applicable policy principles, (5) requires minimal technical expertise to comprehend fully, (6) remains unchanged for a long period, or (7) is able to be applied by the several decision-making institutions without variance. No doubt, many specific rules adopted in the name of simplicity have fulfilled their role. The current exclusion of gain from the sale of a principal residence,<sup>449</sup> for example, collapsed two Code provisions into one. Since prior law conferred exclusion at the cost of a carryover basis in a new residence, the new law allows taxpayers to dispense with the need to keep track of their investments in their residences. On the other hand, the new law allows all taxpayers to exclude such gains even where they do not reinvest the proceeds in similar properties, which represents a further departure

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<sup>449</sup> See I.R.C. § 121. Under prior law, the Code provided for nonrecognition of the gain from the sale of a residence if the proceeds were rolled over into a new residence within two years of the sale. I.R.C. § 1034, *repealed by* Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 312(b), 111 Stat. 839 (1997). Additionally, former section 121 provided sellers age fifty-five and over a one-time forgiveness of a limited amount of gain. I.R.C. § 121, *amended by* Taxpayer Relief Act of 1997 § 312(a).

from the general rule that the Code recognizes all gains not reinvested in property of a like kind.<sup>450</sup> On balance, however, there is no question that the current rule is much simpler than the old rule.

### *B. Simplicity as a Means to Other Ends*

While simpler laws may have superficial appeal to taxpayers, the simpler rule is not always the better rule. For example, Congress could fundamentally simplify the Code by enacting a flat tax on all realized accessions to wealth, together with laws requiring the tax to be withheld at the time of realization. This regime would be simpler than the current one because it would eliminate many exclusions, deductions, and credits that complicate the assessment of tax liability. It would also allow for centralized assessment that has proven to be effective in the context of income tax withholding for wages. Just about the only complexity to this alternative tax system is determining what constitutes a “realized accession to wealth.” As long as Congress provided sufficient parameters in defining the tax base, the complexity would relate to the application of a single rule. The total complexity of the alternative tax system would certainly be less than the aggregate complexities in the current system. Yet such a simple system has no real constituency, largely because it violates accepted notions of equity and efficiency. The flat tax component of the proposal violates vertical equity. Taxing all realized accessions to wealth violates horizontal equity. Instituting comprehensive tax withholding sacrifices the benefits of voluntary assessment. While the alternative tax system seems appealing at first blush due to its simplicity, a closer look soon reveals its unacceptable flaws.

As the preceding example demonstrates, Congress should reject simple rules that thwart equity or efficiency. Accordingly, the criterion of simplicity should not be on an equal plane with equity and efficiency. Unlike equity and efficiency, simplicity lacks inherent virtue. Equity is good.<sup>451</sup> No one argues that an equitable state is

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<sup>450</sup> I.R.C. §§ 1001(c), 1031, 1033.

<sup>451</sup> Because the tax application of equity embraces notions of both horizontal and vertical equity, the term should not be interpreted to mean that a state where all individuals have equal incomes, assets, and status is superior to a state where incomes, assets, and status vary. Instead, an equitable tax state is one where individuals with the same amount of the tax base (whether income, assets, or some other base) are taxed equally and where individuals with a greater amount of the tax base pay more tax than those with a lesser amount of the tax base.



morally or functionally flawed.<sup>452</sup> Likewise, efficiency in the law is good. As with equity, there is no discernible drawback to pursuing efficient laws, except perhaps to the extent that a more efficient law comes at the cost of equity. When equity and efficiency conflict, policymakers must seek a balance between these two important values. Equity and efficiency may be as impossible to achieve as simplification, but advances in equity and efficiency are intrinsically good. Simplicity, on the other hand, is not inherently good. As this article has shown, simple tax laws may be good or bad, depending upon their effect on equity on efficiency. To the extent simple tax laws enhance equality and efficiency they are good. They are not good strictly because they are simple – they are good because they promote the other, more important objectives. No one would argue that equity is good because it is simple; nor would anyone contend that efficiency is good because it promotes simplicity. Simplicity, therefore, is a means and not an end. If simplicity were more often than not a helpful means to the ends of equity and efficiency, one could at least argue that simplicity was generally a good thing. Again, however, the propensity for simplicity to do just as much damage to these core values, as much as it might help them, cuts against this argument. For all of these reasons, simplicity should not be held in the same regard as equity and efficiency when evaluating a tax. If it were, we would risk sacrificing the inherent virtues of equity and efficiency in the name of a more questionable goal.

Although simplicity is not an inherent virtue, we should not warmly embrace tax complexity either. Indeed, complexity too is but a means to an end. In general, this article has shown that complexity can be helpful (sometimes necessary) in enhancing equity and efficiency. Of course, tax complexity can also interfere with these core values.<sup>453</sup> If one adopts a mindset that simplicity is just as important as equity and efficiency, then it becomes hard to resist the temptation to cut wide swaths through the thicket of complex Code and regulation provisions. Just as one ought not perform microsurgery with a hatchet, one should not reform the tax laws solely

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<sup>452</sup> With respect to vertical equity, of course, scholars have debated the philosophical underpinnings of the instinctive preference for progressive tax rates. See, e.g., WALTER BLUM & HARRY KALVIN, *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953); Byrne, *supra* note 29. But these scholars conclude that vertical equity is still desirable, even though an articulate justification of its desire may prove elusive.

<sup>453</sup> For an eloquent argument on this subject, see McCaffery, *supra* note 5, at 1284-91 (with respect to equity), 1292-98 (with respect to efficiency).

on the basis of simplification.

### C. Simplicity as a Component of Efficiency

Simplicity is a component of efficiency, not a separate criterion for evaluating a tax.<sup>454</sup> There are several components to the efficiency criterion, including neutrality, capital allocation, compliance and opportunity costs, and administrability.<sup>455</sup> Under the neutrality standard, a tax should interfere as little as possible with taxpayer behavior.<sup>456</sup> While every tax will affect behavior to some extent, both the government and the taxpayers have an interest in keeping a tax as neutral as possible.<sup>457</sup> For the government, a neutral tax means that the government can rely upon a steady flow of tax revenues. If the tax does not interfere with behaviors that exist in a tax-free market,

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<sup>454</sup> See Butler, *supra* note 29, at 72-73; see also Lustig, *supra* note 29, at 267-68. Professor Graetz similarly contends that simplicity is a component of the equity criterion. MICHAEL J. GRAETZ, *FEDERAL INCOME TAXATION PRINCIPLES AND POLICIES* 18 (2d ed. 1988).

<sup>455</sup> One commentator measures the efficiency of the tax laws by the extent to which they encourage savings. See John S. Nolan, *The Erwin Griswold Lecture*, 12 AM. J. TAX POL'Y 207, 214-15 (1995). This standard clearly contradicts the neutrality standard for efficiency. As many more commentators refer to the neutrality standard, one understandably concludes that this "pro-savings" standard merits little consideration herein. Other commentators measure efficiency in terms of economic growth. Under this standard, a tax that stimulates overall economic growth is efficient. See, e.g., Edward Yorio, *The President's Tax Proposals: A Major Step in the Right Direction*, 55 FORDHAM L. REV. 395 (1987). Again, however, this standard for efficiency violates both the neutrality standard and the capital allocation standard, so it is not developed herein.

The contradictory standards used to measure efficiency suggest that efficiency ought not be given the same deference as equity in evaluating a tax. The problem, of course, is that reasonable minds can (and do) also disagree as to the meaning of equity. See, e.g., Patrick B. Crawford, *The Utility of the Efficiency/Equity Dichotomy in Tax Policy Analysis*, 16 VA. TAX REV. 501 (1997). However one defines equity or efficiency, there is at least a consensus that these criteria are legitimate goals of federal tax policy.

<sup>456</sup> See Butler, *supra* note 29, at 73; see also GRAETZ, *supra* note 454, at 17; J. Clifton Fleming, Jr. et al., *Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income*, 5 FLA. TAX REV. 299, 350-51 (2001); Richard Schmalbeck, *Income Averaging After Twenty Years: A Failed Experiment in Horizontal Equity*, 1984 DUKE L.J. 509, 526-28 (1984); Victor Zonana, *International Tax Policy in the New Millennium: Developing an Agenda*, 26 BROOK. J. INT'L L. 1253, 1255 (2001).

<sup>457</sup> Judge Sneed contends that the perfectly neutral tax would have the broadest possible base and no exclusions. Sneed, *supra* note 29, at 587-89.

the government knows that the behavior it is taxing will continue, thus assuring the government of predictable revenues from the tax. A neutral tax is also optimal for taxpayers because the pain of paying the tax is not as sharp. By definition, the neutral tax will not discourage taxpayers from engaging in the activity subject to tax. Thus, the tax must not be so painful as to alter behavior. Neutrality is but one component of efficiency. As evidenced earlier, Congress intentionally violates the neutrality standard from time to time specifically because it wants to encourage behaviors that are not occurring in the free market or discourage behaviors that are or would be present in the free market.<sup>458</sup>

The allocation of capital in the market also impacts efficiency. An efficient tax should not prefer one allocation of capital over another.<sup>459</sup> If the income from one sector of the market is subject to tax at a higher rate than other market sectors, capital will flow away from the high-tax sector toward the low-tax sectors.<sup>460</sup> This standard is akin to the neutrality standard in that it values nondiscrimination, but it is unique in that it does not necessarily accept the free market biases as superior. If the tax-free market prefers one sector over another, the neutrality standard would seek to preserve this bias. The capital allocation standard would be more concerned with treating all sectors equally if there were no rational basis for the free market bias for or against a particular market sector. Even if one thinks of capital allocation as a redundant restatement of the neutrality standard, one would accept that capital allocation is an important aspect of efficiency.

An efficient tax also requires fewer compliance and opportunity costs than an inefficient one.<sup>461</sup> If a tax requires taxpayers to maintain separate records that would not exist but for the tax, or if the tax diverts resources away from the production of income and toward compliance with the tax (thus representing foregone income), it is less efficient. A more efficient tax requires less compliance time. If the tax is an income tax, the cost standard is especially relevant because presumably the taxpayer could apply the time and resources lost to compliance toward the production of additional income, which would

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<sup>458</sup> See *supra* Part II.A.1.

<sup>459</sup> This point is developed in Razeen Sappideen, *Imputation of the Corporate and Personal Income Tax: Is It Chasing One's Tail?*, 15 AM. J. TAX POL'Y 167, 192 (1998).

<sup>460</sup> *Id.*

<sup>461</sup> See Jay A. Soled, *A Proposal to Lengthen the Tax Accounting Period*, 14 AM. J. TAX POL'Y 35, 47-50 (1997).

enhance revenues.<sup>462</sup>

Finally, an efficient tax should be one that the government can enforce relatively easily.<sup>462</sup> Government resources dedicated to collection and enforcement strains the tax base to produce additional revenues to cover these additional costs. A tax that requires more resources to administer is less profitable and thus less efficient for the government.

The desire for simplicity is in essence a reflection of the cost standard to taxpayers and the administrability standard to the government. A simple tax in theory is more likely to present fewer compliance and opportunity costs for taxpayers, and fewer enforcement costs for the government.<sup>463</sup> Thus, the benefit of simplicity is its advancement of the standards of efficiency. It is a mistake to distinguish simplicity as a tax policy criterion distinct from efficiency. Simplicity is part of what scholars mean by efficiency, nothing more.

If simplicity is merely a substitute for the cost standard for efficiency, it is wrong to treat simplicity as an additional tax policy criterion. By doing so, one devalues the neutrality and capital allocation standards that also contribute to an efficient tax. An example illustrates the mistake of treating simplicity as a separate criterion. Assume that Congress is debating a particular proposal that would amend the Code. There is universal consensus that the proposal would significantly enhance the overall simplicity of the tax laws by reducing compliance and enforcement costs, but there is also a universal consensus that the proposal violates neutrality because it will cause taxpayers to engage in behaviors that would not normally occur in the free market and are not otherwise desirable. Assume further that everyone agrees the proposal will afford a small benefit for a certain class of taxpayers with incomes equal to those of other taxpayers outside of that class for no legitimate policy reason. The proposal thus violates horizontal equity, but the violation is not very significant. Illustrated numerically the hypothetical proposal scores as follows:

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<sup>462</sup> Several commentators refer to this standard as “administrability.” See, e.g., Patrick B. Crawford, *Analyzing Fairness Principles in Tax Policy: A Pragmatic Approach*, 76 DENV. U. L. REV. 155, 186 (1998); John S. Nolan, *The Merit of an Income Tax Versus a Consumption Tax*, 12 AM. J. TAX POL’Y 207, 218 (1995); Soled, *supra* note 461, at 50.

<sup>463</sup> But see *supra* Parts III.B., III.C. (finding arguments calling for tax simplification based on the compliance and enforcement costs of tax complexity unpersuasive).

Enhanced Simplicity	+ 4
Diminished Neutrality	- 3
Diminished Horizontal Equity	- 2

From an efficiency standpoint, the proposal has a net score of +1 because the enhanced simplicity more than offsets the diminished neutrality. The efficiency gain, however, is itself more than offset by the loss in horizontal equity. The proposal should not pass, assuming one has an equal preference for the efficiency and equity criteria. Those who consider simplicity a separate criterion would adopt the proposal. By double-counting simplicity, the proposal scores a net +3 (+4 for simplicity, +1 for efficiency, and -2 for equity), meaning it is net beneficial.

One might counter that such double-counting is not necessarily a result of elevating simplicity on a par with equity and efficiency. One could simply strip the efficiency criterion of its compliance costs and administrability standards, measuring efficiency solely with reference to neutrality and capital allocation.<sup>464</sup> While that avoids the double-counting problem in the illustration, it implicitly gives more weight to the four efficiency standards, making equity a less important criterion. Consider a separate tax proposal that scores as follows:

Diminished Simplicity	- 1
Diminished Neutrality	- 1
Enhanced Equity	+ 2

If one treats efficiency as consisting only of the neutrality standard and does not double-count the diminished simplicity, the proposal is a push – one should neither favor nor disfavor the proposal. Of course, the same result follows even if one considers simplicity to be a component of efficiency – the net result is still a push because the +2 gain in equity is offset by the -2 loss in efficiency (again assuming that both criteria count equally). The danger of considering simplicity separately lies in the temptation to treat criteria equally. If one thinks there are three equal criteria (equity, efficiency, and simplicity) and not just two (equity and efficiency), then the right answer is to reject the proposal. While the literature is usually careful to proclaim that

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<sup>464</sup> This approach has been used. See, e.g., Rebecca S. Rudnik, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W. RES. L. REV. 965, 1200-01 (1989).

one should not necessarily weigh the tax policy criteria equally,<sup>465</sup> the natural inclination is to do so. By separating efficiency into two separate criteria, one devalues the equity criterion. This result is acceptable only if one universally considers efficiency to be more important than equity, which again is contrary to the cautions against equal weighing.

Since simplicity is a component of tax efficiency, it does not deserve its accustomed status as a separate and distinct policy criterion. By doing so, policymakers are tempted to devalue other components of efficiency or even the equity criterion.

## VI. CONCLUSION

Tax complexity is neither bad nor good, and tax simplicity is neither bad nor good. The current political paradigm denouncing the Code as “too complex” and lauding reforms that will “simplify” the tax laws is misguided. In evaluating the Code and any proposed reforms to the Code, more attention should focus on promoting the core values of equity and efficiency. If complexity is necessary to have more equitable and efficient laws, that complexity should be acceptable. Crusades to simplify the Code should be suspicious because simplicity is not always the best way to advance the core values.

The staff of the Joint Committee on Taxation deserves credit for identifying the many expired provisions that still exist and unnecessarily clutter the Code.<sup>466</sup> The Joint Committee should also receive commendation for questioning the complexity of many Code provisions. It is important to revisit complicated provisions from time to time to make sure that the equity and efficiency objectives sought by Congress advance. As the Joint Committee staff concedes, one cannot simplify the Code without altering fundamental tax policy positions. If a simplification proposal furthers legitimate objectives of tax policy, the proposal merits serious consideration. Simplification merely for the sake of simplification, however, is not productive.

The Code is a carefully crafted work of political compromise. Like all of us, it contains some fat that could be trimmed, an organ or two that could be severed without damage to the body, and maybe

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<sup>465</sup> See *supra* note 29.

<sup>466</sup> 2 JOINT COMM. ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986, at 579-93 (Joint Comm. Print 2001).

some features that are less appealing to look at than others. It also has an inner beauty and an intricate structure that generally works to raise revenues for the many programs that benefit the taxpayers from whom it collects. While there are many exceptions to the basic themes, the Code is generally predictable to one who understands the themes and the political pressures that shape the exceptions. We could easily have a simpler tax regime, but the resulting inequities and inefficiencies would likely outweigh the compliance burdens placed on taxpayers under the current tax regime.