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## Guiding principles for tax law transparency; Tax Policy Concept Statement 3

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# Guiding Principles for Tax Law Transparency

Issued by the Tax Division of the  
American Institute of Certified Public Accountants

## **NOTICE TO READERS**

Tax Policy Concept Statements of the AICPA Tax Division are issued for the general information of those interested in the subject. They present the conclusions of the Division, as approved by the Tax Executive Committee. The Tax Executive Committee is a senior technical body of the AICPA authorized to speak for the AICPA in the area of taxation.

Tax Policy Concept Statements are intended to aid in the development of tax legislation in directions that the AICPA believes are in the public interest.

Tax Policy Concept Statements do not establish standards enforceable under the AICPA's Code of Professional Conduct and are not intended for that purpose.

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

# Guiding Principles for Tax Law Transparency

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## FOREWORD

This is the third in a series of tax policy concept statements issued by the AICPA Tax Division on tax policy matters. It is intended to aid in the development of tax legislation in directions that the AICPA believes are in the public interest.

Tax policy concept statements are approved by the Tax Executive Committee of the AICPA Tax Division after they are developed and approved by the division's Tax Legislation and Policy Committee. Other division committees and technical resource panels may develop tax policy concept statements if requested to do so.

This statement was developed by the 2001-02 and 2002-03 Tax Legislation and Policy Committee. It was approved by the 2002-03 Tax Legislation and Policy Committee and the 2002-03 Tax Executive Committee. Members of the bodies that approved this tax policy concept statement are listed below.

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The AICPA Tax Division gratefully acknowledges the significant contributions of Betty R. Jackson in the development of the direction and the drafting of the statement.

## Guiding Principles for Tax Law Transparency

### THE TRANSPARENCY PRINCIPLE

A good tax system — one that facilitates and encourages compliance — needs to be understandable to those who are expected to pay the tax and by those who administer the tax. In Tax Policy Concept Statement No. 1, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, the AICPA sets forth ten guiding principles. One of the principles, transparency, is the basic notion that taxpayers should know, namely, (1) that a tax exists; and, 2) how and when the tax is imposed on them and others.

In Tax Policy Concept Statement No. 2, *Guiding Principles for Tax Simplification*, the AICPA explores the importance of reducing complexity in the law. Transparency is an important partner with tax simplification. The more complex a tax system is, the less transparent it tends to be. Complexity obscures how, when, and on whom a tax is imposed, which increases confusion, frustration, and the perception that the tax is unfairly imposed and thereby decreases compliance. Transparency is critical for understanding the impact of any given tax.

### WHY TAX LAW TRANSPARENCY IS IMPORTANT

If taxpayers and their advisers cannot understand the tax system, they cannot evaluate the impact of that system. Beyond the fundamental aspect of actual and perceived fairness, proposing understandable changes to an understandable tax system would result in broader consensus on whether a change is necessary, wise, or effective. A tax that is not understandable can be easily retained or raised with little awareness among taxpayers about how the tax affects them. Without transparency, “gimmicks” such as deduction, exemption, and credit phaseouts for raising revenue flourish and more appropriate, fundamental approaches such as increases in statutory tax rates are avoided.

The tax system is a primary link between citizens and their government, with a significant influence on citizen attitudes toward government. In 1972, Americans rated the income tax as the *fairest tax*; but by 1979,

most people rated it as the *most unfair tax*<sup>1</sup>. This downward trend continues. If taxpayers cannot clearly “see” their tax burdens, they view the entire system as unfair. Some taxpayers have come to believe that they are entitled to a lower tax bill and resist in the only way they can — by exerting more effort to find ways of reducing their tax bills, legitimately or otherwise. These efforts put additional pressure on our self-assessment system that depends heavily on taxpayers’ willingness to comply.

Recently, transparency in financial reporting has become a top priority, recognized even in the mainstream media. Transparency in financial reporting by public companies is measured by “the extent to which financial information about a company is available and understandable to investors and other market participants.”<sup>2</sup> Transparency in tax law should be measured by how easily taxpayers can determine whether and how any particular tax provision — and the tax statute as a whole — affects their tax burden.

As an example of the problems faced by the tax system, Department of the Treasury Assistant Secretary for Tax Policy, Pam Olson described the international tax rules as “hard to understand, messy, inconsistent, and display[ing] little regard for the real world.”<sup>3</sup> This same statement could be made with respect to many federal and state tax rules today because they are obscured.

Obscurity in the tax law may cause harm by:

Creating significant inequities, both real and perceived.

Impairing government’s ability to administer the tax system.

Allowing opportunities for tax evasion and aggressive tax avoidance techniques.

Frustrating taxpayers and tax advisers when they attempt to plan transactions and comply with the law.

Resulting in unintentional misstatements of income and deductions.

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1. *The Decline [and Fall?] of the Income Tax*, by Michael J. Graetz, New York, NY: W.W. Norton & Company, Inc., 1997.

2. Statement by John M. Morrissey, Deputy Chief Accountant, U.S. Securities and Exchange Commission, in testimony before the Subcommittee on Oversight and Investigations, Committee on Financial Services, March 21, 2002.

3. Remarks of Pam Olson, Assistant Secretary for Tax Policy, before the IRS/George Washington University 15th Annual Institute on Current Issues in International Taxation, December 12, 2002.

Creating inefficiencies that impede taxpayer decision-making and undermine economic development.

Imposing significant costs on taxpayers, tax advisers, and the government.

Increasing the transparency of the tax law should:

Result in a system that is and is perceived by taxpayers as being fairer.

Enhance the efficiency of administering the tax system.

Decrease tax evasion.

Diminish the incentive to use overly aggressive tax avoidance techniques.

Increase taxpayer and tax practitioner certainty in tax planning and compliance.

Reduce tax return error rates.

Provide a stimulus for growth by making economic decision-making more efficient.

Reduce the direct and indirect costs of complying with and administering a complex and nontransparent tax system, freeing up resources for productive activities.

Too little transparency affects everyone dealing with the tax system:

*Taxpayers.* Taxpayers at all education and economic levels have the right to be able to comprehend both the *tax base* (the amount upon which a tax will be levied) and the *tax rate* that will be imposed. Currently, taxpayers face a bewildering array of ambiguities about the tax base which result from multiple definitions of identical terms, interactive provisions, phaseouts, disallowance of certain tax benefits as income rises, and the increasing possibility of falling into an alternative tax system, e.g., the alternative minimum tax (AMT). Taxpayers are also challenged in determining their tax rate under the combination of an expanding menu of applicable “regular” income tax rates, phaseouts which change effective rates as income rises, and potential alternative tax rates under the AMT system.

*Tax Practitioners.* Efficient decision-making requires that tax advisers be able to integrate reasonable approximations of relevant tax consequences as they encounter or plan economic transactions. This is very difficult today, even in some of the most routine aspects of our economic lives. The difficulty of estimating tax effects is increasingly burdensome and a drag on economic activity and development.

*Tax Administrators.* The tax system's administrators must be able to understand the system sufficiently to (1) provide timely, comprehensible guidance to taxpayers and their advisers and, (2) be able to enforce the law and make the appropriate collections. The growing burden placed on tax administrators significantly reduces efficiency and impedes effective interactions with taxpayers and advisers.

*Lawmakers and Policy Analysts.* In order to evaluate how fairly the tax burden is distributed, lawmakers and policy analysts must be able to see clearly how and to whom various taxes apply, how laws are complied with, and the revenue generated by various provisions in the law.

The AICPA and other concerned observers believe that we have reached a critical juncture. Improving the tax system's transparency will be the more difficult choice in the short run; but by making transparency a priority in the legislative process and by developing procedures in legislative and regulatory processes to avoid obscuring the true tax burden, we can reverse the detrimental effects and provide long-term benefits for taxpayers and the economy.

## **AICPA TAX POLICY STATEMENT**

In this document, Tax Policy Concept Statement No. 3, *Guiding Principles for Tax Law Transparency*, the AICPA affirms its support of efforts to improve the transparency and visibility of our federal and state tax laws. This entails bringing an end to the unnecessary mechanical complexity and backdoor revenue provisions which obscure taxpayers' ability to identify the true cost of transactions, what their total tax liability is, and which level of government is being paid the tax. Increased transparency will reduce the complexity and improve the perceived fairness of our tax system, benefiting all constituents of the tax system.

## **A ROADMAP FOR TAX LAW TRANSPARENCY**

The AICPA recommends that the following guiding principles be used in the development of more transparent tax legislation:

*Make the promulgation of a good tax system a priority.* Transparency is a key principle of good tax law. Unfortunately, it has not been a high priority in tax legislation in recent years. For the law to become more transparent, lawmakers must recognize transparency's significance in achieving: a fair tax law, improved compliance, and a healthy economic environment.

*Implement transparent approaches.* Lawmakers should thoroughly review tax statutes to identify and eliminate features that systematically obscure the tax base and tax rate. To the extent feasible, existing provisions should be revised. In addition, all prospective provisions should be evaluated against the transparency principle. For example, any proposed change to the tax law should address whether taxpayers will be able to understand their true tax rate and have confidence in calculating their tax base. If the answer is *no*, additional work is needed to make the proposal follow the transparency principle.

Actions that must be taken in order to follow the guiding principles set forth above include (more detailed discussion and examples are provided in the next section):

*Eliminate and avoid phaseouts.* Phaseouts create difficulties in estimating a taxpayer's marginal tax rate and in determining the ultimate tax cost or tax savings of any economic choice.

*Eliminate and avoid interactive provisions.* Interactive provisions, which apply if a taxpayer engages in specific transactions, benefits from certain deductions, or exceeds a range of income limitations, complicate taxpayers' determinations of their tax bases or their tax rates; thereby, obscuring the impact of any given provision.

*Adopt uniform definitions of terms for all statutory purposes.* Inconsistent concepts and definitions are unnecessarily confusing and obscure the law's purpose and impact.

*Avoid multiple effective dates and sunset dates.* Multiple effective dates and sunset dates create confusion and obscure the law's effect.

## EXPLANATION OF THE ROADMAP

### **Make the Promulgation of a Good Tax System a Priority**

Political expediency has driven the implementation of many provisions that harm constituents of the tax system by concealing the tax base and tax rates. Transparency, a key principle of good tax law, has devolved from an accepted ideology into a nearly zero-priority concern.

Transparency is tightly intertwined with the broad principle of simplification. Multiple calculations using different sets of rules, definitions, and reference points have become exceedingly complex. The resulting lack of transparency leads to higher levels of confusion and errors on



the part of taxpayers and greater administrative costs for the Internal Revenue Service (IRS).

The tax law has become virtually impenetrable, not only to most taxpayers but also to many tax experts. *Money* magazine's annual comparative study of standard returns prepared by professionals regularly results in a wide variety of final tax calculations. It also demonstrates that the relative correctness of the returns does not reflect either the time spent or fees charged. Furthermore, the study shows that IRS personnel, who are responsible for administering the tax system, also have difficulties in calculating tax liabilities.

### **Implement Transparent Approaches**

Revenue needs, as well as economic and social objectives, will always drive tax law changes, but necessary rate changes should be straightforward and visible. Although it may seem obvious, a taxpayer's effective marginal tax rate should be the same as the statutory rate, thus enabling taxpayers to reasonably anticipate their ultimate tax rate. Many taxpayers still experience marginal rates substantially higher than the statutory rate. Taxpayers commonly have no confidence in their ability to calculate their own tax rate or their taxable income, even after consulting with their tax advisers.

Although the following examples focus on federal individual income tax law, the concepts apply equally to state tax law, other types of taxes, and other types of taxpayers.

**Example 1:** John and Mary Taylor are both age 65 and file a joint tax return for 2003. They have \$38,600 of retirement plan and other ordinary income, and \$18,000 of social security benefits. They claim the standard deduction. Their taxable income is \$30,160 (\$38,600 of retirement plan and other ordinary income, \$9,060 of taxable social security, less \$11,400 standard deduction and \$6,100 personal exemption). Their income tax is \$3,824 (15-percent bracket).

Next, assume that all the facts are the same as above, but the taxpayers receive an additional \$1,000 of retirement plan income. The Taylors' taxable income increases by \$1,850 (\$1,000 additional retirement income and an \$850 increase in the taxable portion of their social security) to \$32,010. Their income tax increases by \$278 (27.8 percent of their incremental income, even though they remain in the 15-percent tax rate bracket) to \$4,102.

Starting with the same original example, next assume that the Taylors instead realize \$1,000 of capital gain from the sale of

stock that they have held for more than one year (rather than have \$1,000 of retirement plan income). Their taxable income increases by \$1,850 (\$1,000 additional capital gain with an \$850 increase in the taxable portion of their social security) to \$32,010. Their income tax increases by \$178 (17.8 percent of their incremental income, even though they remain in the 15-percent tax rate bracket and their long-term capital gain rate is 5 percent) to \$4002.

In each situation, \$1,000 of additional ordinary or long-term capital gain income does not result in \$150 or \$50 of additional tax for someone in the 15- or 5-percent tax bracket respectively, but instead has differing results. Very often, the taxpayer will not understand the tax impact of a change in financial circumstances until they ultimately prepare their tax return or seek professional advice.

Unnecessary mechanical and complex calculations, ambiguous definitions, and complicated interactions with other provisions should be identified and eliminated. Backdoor provisions that affect the tax base and tax rate under certain circumstances should be eliminated in favor of straightforward tax-base or tax-rate adjustments. Formal procedures restricting the use of these types of “problem provisions” can be developed to promote future transparency.

### **Eliminate and Avoid Phaseouts**

Until the Tax Reform Act of 1986, deductions and credits were generally not subject to phaseouts. Since then, the standard de facto method of increasing revenue (and changing tax rates) has been to phase out exemptions and deductions at specific income levels. These phaseouts have dramatically complicated the law and proliferated without common, coherent guidelines for determining threshold amounts, phase-out ranges, or applicable percentages. Practitioners are burdened daily by the lack of transparency resulting from phaseouts, which complicates their workloads and confuses their clients.

**Example 2:** Robert and Ann Smith file a joint tax return in 2003 listing ordinary income of \$140,000 and \$15,000 of itemized deductions from taxes and charitable giving. Their taxable income is \$118,915 (\$140,000 less \$6,100 in personal exemptions and \$14,985 in itemized deductions [\$15,000 net of an itemized deduction phaseout of \$15]). Their tax is \$23,477, and they are in the 28-percent bracket.

If the Smiths have an additional \$10,000 of ordinary income, their taxable income increases by \$10,300 (\$10,000 additional

ordinary income, plus \$300 more in disallowed itemized deductions) to \$129,215. Their income tax increases by \$2,884 (28.8 percent of their incremental income) to \$26,361 even though they remain in the 28-percent bracket.

**Example 3:** Sam and Sarah Jones file a joint return for 2003 listing ordinary income of \$209,200 and \$20,000 of itemized deductions from taxes and charitable giving. Their taxable income is \$185,191 (\$209,200 less \$6,100 in personal exemptions and \$17,909 in itemized deductions [\$20,000 net of an itemized deduction phaseout of \$2,091]). Their tax is \$42,559, and they are in the 33-percent bracket.

If the Joneses have only an additional \$100 of ordinary income, their taxable income increases by \$225 (\$100 additional ordinary income, plus \$3 more in disallowed itemized deductions and a \$122 decrease in personal exemptions) to \$185,416. Their income tax increases by \$74 (74 percent of their incremental income) to \$42,633, even though they remain in the 33-percent bracket.

As a result of the hidden tax imposed by the phaseouts of itemized deductions and personal exemptions, neither the Smiths nor the Joneses can accurately predict the impact of a change in their financial circumstances based on their tax bracket.

As noted in a September 13, 2002, submission to the Department of Treasury by the AICPA<sup>4</sup>:

Under current law, phaseouts complicate tax returns immensely and impose marriage penalties. Phaseout instructions are difficult to understand and the average taxpayer cannot manage the complex calculations. In addition, the differences in phaseout methods and definitions of income cause a compliance burden on many individuals and make it difficult for taxpayers to recognize when they are eligible for a benefit and when and how any phaseout applies. Tremendous income-level differences exist across the various programs using phaseouts. As it stands, some phaseouts are so complicated that neither the targeted taxpayers nor those charged with explaining and administering the rules are able to accurately understand and interpret them.

### **Eliminate and Avoid Interactive Provisions**

Interactive provisions such as investment interest limitations or passive activity losses complicate determinations of the tax base and tax rates

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4. Identical submissions were also made by the American Bar Association Section of Taxation and the Tax Executives Institute.

by segregating certain income and deductions into “baskets” and applying separate, and often complex, rules to each of those baskets. Then taxpayers are required to maintain records to carryover currently disallowed deductions to future years.

The most egregious example of the problems created by interactive provisions is the AMT. The AMT obscures both the tax base and the tax rate by exposing taxpayers to a second tax system with many different rules and a different tax rate. Originally designed as a “class tax,” the AMT is now a looming “mass tax,”<sup>5</sup> because it is not indexed for inflation nor does it take into account the scheduled reduction in the regular statutory rates.

**Example 4:** Fred and Beth Miller have four dependent children and file a joint tax return in 2003. They have ordinary income of \$114,500, \$1,000 of charitable giving, \$12,200 of state taxes, and \$6,000 of mortgage interest. Their taxable income is \$77,000 (\$114,500 less personal exemptions of \$18,300 and itemized deductions of \$19,200.). Their tax is \$9,120 (net of child tax credit of \$3,750), and they are in the 25-percent tax rate bracket.

If the Millers incur \$5,000 of additional state taxes, their taxable income decreases by \$5,000 to \$72,000, and their regular tax decreases by \$1,250 (\$5,000 times their marginal tax rate of 25 percent). However, they now incur \$1,250 of AMT, resulting in no federal tax savings from their additional itemized tax deduction of \$5,000.

Historically, the AMT applied to a relatively small set of very wealthy taxpayers (155 taxpayers in 1969 under the predecessor add-on minimum tax system). However, the AMT grew to affect one million taxpayers in 1999. Based on current projections, the AMT will apply to 36 million taxpayers in 2010.<sup>6</sup> Unfortunately, the growing realization that the AMT must be reformed has met with the cold reality of the burgeoning, projected revenue losses that accompany its repeal or reform. By 2010, “repealing the AMT could cost more than repealing the regular income tax.”<sup>7</sup>

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5. Burman, L. E., W. G. Gale, J. Rohaly, and B. H. Harris, “*The AMT: Out of Control*,” *Tax Policy Issues and Options*, Urban-Brookings Tax Policy Center, No. 5, September 2002, page 1.

6. *Id*

7. *Id*

## **Adopt Uniform Definitions of Terms for All Statutory Purposes**

Multiple and inconsistent definitions create significant, unnecessary confusion. For example, *dependent* and *related party* are defined in different ways for different sections of the Internal Revenue Code (IRC). Considerable taxpayer and administrative resources are spent in trying to reduce planning and compliance uncertainty and errors in light of these inconsistent definitions. A *tax term* used in multiple sections of the statute should have only one definition for all statutory purposes. This in turn helps taxpayers understand whether a provision does or could apply to them.

## **Avoid Multiple Effective Dates and Sunset Dates**

Multiple effective dates and sunset dates create confusion as to when a provision applies. The problem is compounded by expiring provisions that are regularly extended and frequently applied retroactively.

## **CHALLENGES**

Creating a transparent tax system has its challenges. However, these challenges must not discourage us from steadily improving the transparency of our tax laws. Significant improvements are possible if legislators recognize the benefits that will accrue to all participants and vigorously tackle the challenge. By recognizing the ways in which our tax system has obscured tax bases and tax rates, we can reverse the trend of proliferating phaseouts and interactive provisions, and guide future tax law design toward greater transparency.

Revenue demands will always be an intrinsic barrier to a transparent tax system. Crafting tax law is admittedly difficult. There are usually no politically easy methods to adjust revenue and lawmakers frequently choose methods that will result in the least public outcry. Taxpayers need to be educated about the actual impact on effective tax rates of backdoor approaches. They need to understand that direct rate increases, to raise the same amount of revenue, are preferable from a “good tax policy” standpoint.

Structural components of our economy that also complicate the law-making process include:

1. The financial lives of businesses and individuals are inherently complex. The tax laws crafted to address this complexity frequently lack transparency.

2. Businesses face two competing regimes for their different financial reporting purposes, namely, (a) the need for accurate and useful financial reporting for investors and other users of financial information, and (b) compliance with and reporting for tax systems that are increasingly used to implement social and economic policies. The resulting differences between calculating reported financial income and taxable income increase the burdens imposed on business and impairs the comparability of the two measures.
3. Legislators have difficulty balancing the often conflicting objectives of meeting revenue targets, achieving social change, providing economic stimulus, and maintaining broad fairness and equity in the system.
4. The existing tangle of tax provisions makes anticipating the complexities that might flow from new provisions extremely difficult.<sup>8</sup>

Lawmakers must become convinced that improving transparency is an important goal for the legislative process. Methodical review and analysis should be undertaken to identify aspects of the law that obscure the tax base and tax rate. Existing provisions should be modified and prospective provisions should be tested for clarity. A significant amount of transparency can be restored by some of the same means which will simplify the statute, such as (1) eliminating phaseouts; (2) eliminating interactive provisions; (3) adopting uniform definitions of terms; and, (4) avoiding multiple effective dates and sunset dates.

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8. The problems resulting from these inherently complex issues have been previously addressed in Tax Policy Concept Statement No. 2, *Guiding Principles for Tax Simplification*. Simplifying the tax law will directly improve its transparency.



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