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## **The Enormous Complexity Of Being Fair.**

In Perspectives on Guidance, Hal Gann and Roy Strowd discuss the costs of tax complexity and the costs of simplification.

### **===== SUMMARY =====**

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Each month, the authors will analyze a recent development in tax guidance, e.g., regulation, IRS pronouncement, statute, or court decision. They will offer their insights and suggestions, and hope that readers will, as well.

### **===== FULL TEXT =====**

A few years back, "SIMPLIFY" became a mantra for the Service and the Treasury Department, as well as some taxpayers and practitioner groups. The fact of the matter was (and is) that the complexity of our tax system was bowing, if not quite breaking, our backs. Nevertheless, the mantra has pretty much worn off and it is fairly common today for people to regard references to simplification as mere "cocktail party talk." It is easy to cite examples where Congress has written complex new code provisions, or where the IRS and Treasury have written complex new regulations, but why is the law becoming so complex? Is there nothing that the Congress, IRS, Treasury, taxpayers, and practitioners can do about it? Is there an identifiable constituency that will support simplification, even if it sometimes costs taxpayers a little tax or the fisc a little revenue?

We think it is clear that the principal cause of complexity is the desire to measure taxpayers' liabilities with ever-greater precision. Precision is desirable because it reduces economic distortions, because it increases equity by more accurately measuring taxpayers' relative incomes, because it often raises additional revenue without raising rates (which can also be expressed as a preference for taxing everyone equally before raising the rates on some), and because it increases respect for the tax system (which is probably just a third way to describe the quest for equity). But ever-greater precision also carries a price. It is fairly simple to compute a taxpayer's foreign tax credit using an overall limitation. If you want to prevent taxpayers with operations in

several foreign countries from using income earned in high-tax countries to shelter income earned in low-tax countries, applying a per-country limitation is a bit more complex. Allowing taxpayers to apply either an overall or a per-country limitation takes you up another rung on the complexity ladder. And if you also want to prevent taxpayers from using high-taxed types of income to shelter low-taxed types of income, a system with numerous "baskets," as well as an overall limitation, is several rungs higher still. Asking individuals, as well as corporations, to climb this ladder is really asking a lot.

As Congress endeavors to make each subchapter of the code similarly precise, it becomes difficult to fit the entire code into two volumes, the regulations necessarily expand to fill six volumes, and few IRS agents and practitioners find themselves able to "keep up" with the detailed rules in more than a few areas of the law. Each increment of precision carries with it a series of additional tax forms and related compliance costs, as well as an additional investment of resources in corporate tax departments. The resulting frustration causes a loss of respect for the tax system, which was, of course, a principal reason for pursuing greater precision in the first place.

The conventional response is that as the world economy becomes increasingly complex and dynamic, the tax system must respond with increasingly complex and dynamic rules. But is this conventional wisdom correct? The opportunities for technological improvements in the administration of, and compliance with, the tax system

should be at least as great as the opportunities for technological improvements in other areas of the economy. The tax system should enjoy net efficiency gains like the gains enjoyed by the remainder of the economy.

Sometimes, when the level of precision sought by the statute fails to justify the complexity it causes, the IRS and Treasury can rebalance the two. In Treas. reg. section 1.55-1, the IRS and Treasury got some support for simplifying the individual AMT, even in a way that cost many taxpayers money. When Congress wrote the new AMT in 1986, it contemplated a completely separate and parallel system of taxation. Thus, each of the regular tax rules would operate in a separate and parallel fashion within the AMT system (e.g., a regular tax inventory accounting system and a parallel system of AMT inventory accounting). The legislative history gave Treasury the authority to mitigate the complexity of the separate and parallel system if it could do so without changing the substantive results too much. Unfortunately, no one came forward with suggestions, or even responded to the concerns that the IRS and Treasury expressed about the complexity of the separate and parallel system. /1/ But when the tax forms were revised to reflect the separate and parallel system, the folks who write the tax preparation software became responsive; they could not believe that the law required them to program a "loop" that would completely recompute taxable income from line 7 for any individual with tax preference items. The culprit: any preference item that fell "above the line" caused an increase in adjusted gross income (AGI) that affected the floor on medical expense deductions, the limitation on charitable contribution deductions, the 2-percent floor on miscellaneous itemized deductions, the phaseout of itemized deductions, etc. Of course, the millions of taxpayers who still use pencils to prepare their tax returns were required to perform this "loop" at even greater cost.

The AICPA, which also deserves much of the credit for promoting the "SIMPLIFY" mantra, came forward and asked for simplification, even though it would cost taxpayers some money. The Service responded by proposing and finalizing regulations in 1994 that prohibit individuals from recomputing AGI for AMT purposes. How did taxpayers feel when simplification came at a cost? Some former mantra-chanters found themselves opposing the proposed regulations on behalf of clients. But the AICPA, to its credit, stuck to its principles and supported finalization of the regulations.

Why didn't the Service and Treasury let each taxpayer choose to recompute AGI if he or she felt it was worth the complexity? One reason may have been

administrability; it is simpler for revenue agents and Service Center computers if all taxpayers compute their AMT one way. Also, every election requires rules about how to make the election and how to change the election, and scores of cases inevitably arise where taxpayers mistakenly make, or do not make, the election and want to amend their returns. A second reason may have been revenue; there are winners and losers under either rule, but there are only winners if each taxpayer can choose his or her own rule. Finally, it would be hard to argue that there is any real simplicity in allowing taxpayers this type of choice; many taxpayers (and most tax preparers) would feel compelled to compute their tax liability both ways and choose the method that would minimize their tax.

The question whether choice is simple or complex comes up in a surprising number of regulations. Here are three recent examples:

(1) Treas. reg. section 1.1275-4. The regulations on contingent debt instruments that were almost proposed in January 1993 gave taxpayers so many choices that some commenters bemoaned the complexity of the "Chinese Menu" approach. The current proposed regulations on this topic allow much less choice, and are much more popular with the commenters. Perhaps where precision is impossible, taxpayers prefer simplicity.

(2) Treas. reg. section 1.1502-55. Commenters have noted that the proposed consolidated AMT regulations would take away some of the choices that have always been permitted under the regular tax consolidated return rules, and have urged the government to allow taxpayers to craft methods to fit each taxpayer's circumstances. Unfortunately, finalizing these regulations did not make it onto the 1995 Business Plan. The law appears to be simpler, for revenue agents as well as taxpayers, if a unified method can be prescribed and adhered to by everyone. But is that still true if half of the taxpayers are forced to change their accounting methods to reach unification? The longer it takes to finalize the regulations, the more settled taxpayers will become in their own methods.

(3) Treas. reg. section 1.446-4. The regulations on accounting for hedging transactions bestow upon taxpayers the benefits and the burdens of designing methods of accounting that fit their business needs while "reasonably matching" the recognition of income on hedges to the recognition of income on the items being hedged. These regulations were fairly well-received, but whether taxpayers' methods will become controversial on audit remains to be seen.

It seems clear that in each case, the government tries to balance simplicity against precision, but it is not always

easy to predict how the commenters will react. Nor is it always obvious who should bear the costs of this type of simplification. As we mentioned above, Treas. reg. section 1.55-1, and the simplification achieved therein, often increases individuals' tax obligations. In other cases, simplification will be possible at a reasonable cost to the fisc, and should be pursued there, as well. /2/

Sometimes, the IRS and Treasury are powerless to reduce the complexity of a statutory provision. That is the case, we think, with the section 59A environmental income tax. Introduced by the Superfund Amendment and Reauthorization Act of 1986, this tax applies to all corporations with "modified alternative minimum taxable income" in excess of \$2 million. The tax base was designed as broadly as possible to spread the burden evenly across all corporations and to keep the rate very low. The design was carried out by applying a flat rate of 0.12 percent to "modified alternative minimum taxable income." The tax raises about \$500 million each year to finance the Superfund program, but a recent study by the Brookings Institute and Resources for the Future concluded that corporations' administrative and compliance costs of computing and remitting the environmental income tax may exceed the revenue raised. /3/ We suspect that these cost estimates are overstated, but this tax clearly imposes unnecessary administrative and compliance costs by forcing taxpayers who do not owe any AMT to compute modified AMTI solely for purposes of section 59A. Is there no way to design such a tax without forcing taxpayers to choose between (1) incurring significant costs to compute AMTI, and (2) becoming scofflaws by "guesstimating" their AMTI? Granting that complexity is sometimes needed to achieve precision, we're not convinced that this a case where much precision is needed. After all, the tax is being imposed at a very low flat rate on all corporations. How much less precise would it be to use gross profit as the tax base and lower the tax rate even further? Or to use taxable income as the tax base and raise the tax rate a bit?

Moving from section 59A to the AMT itself, we think it may be time to consider repealing this entire separate and parallel system of taxation. When it was enacted in 1986 as part of the base-broadening and rate-lowering tax reform effort, the AMT raised a significant amount of revenue and answered political criticism that some taxpayers were not sharing the cost of funding government. Some even harbored hopes that our obvious inability to maintain indefinitely two parallel tax systems might lead to repeal of the regular tax, leaving the much broader AMTI as a single, more equitable tax base that could support lower tax rates. But by now it must be clear to everyone that the AMT is a mere shadow of its former self and is only shrinking, both in terms of the

revenue raised and in its ability to ensure that everyone shares the cost of government. It seems to us that the time has come to admit that the AMT is no longer precise enough to justify its complexity. If a minimum tax is still needed to respond to the perception that not all taxpayers pay their fair share, why not return to a much simpler add-on tax on preference items? At the very least, do we need two AMT systems -- a regular AMT system and an ACE system?

As policymakers continue this year to evaluate proposals to replace the income tax with an alternative tax system, costs of compliance and administration must be carefully considered. How will these real-world costs be kept in check as these proposals move from their theoretical frameworks to actual implementation? It is easy to argue that in theory, the costs of imposing a different tax should be much less than the actual costs of our income tax, but the political process through which real tax systems must pass makes it hard to put much faith in theoretical estimates. If, as we suspect, Congress is more likely to enact a second tax system than to replace the income tax system, it is hard to believe that administration and compliance costs will decline. The AMT has taught us that additional tax systems tend to increase, not reduce, complexity.

We encourage policymakers to take steps this year to significantly reduce the real-world compliance costs associated with our current tax system. The environmental income tax and the AMT might be a good place to start. We have focused on the AMT because it is an area of the code that we know. /4/ Maybe you know an area of the code and have ideas about how Congress or the IRS and Treasury could reduce the cost of compliance or simplify the law without being unfair, and without costing the government or taxpayers too much money. If so, please consider sharing your thoughts.

#### FOOTNOTES

/1/ See, e.g., Treasury's request for simplification suggestions in the preamble to proposed regulations regarding adjusted current earnings or "ACE" (55 Fed. Reg. 18629, May 3, 1990). According to the preamble to the final ACE regulations, "The Service specifically requested comments when it published the notice of proposed rulemaking on whether the statute and legislative history required ACE to be a separate tax system, and if so, whether there were ways in which the Service could mitigate the resulting complexity without deviating from the substantive results Congress intended. The Service received no comments on these issues." ( 56 Fed. Reg. 11080, March 15, 1991).

/2/ Treas. reg. section 1.56(g)-1(f)(3) is one example of the government's willingness to pursue such pro-taxpayer simplification measures. The recapture rule in the proposed regulations was a little simpler (and less harsh on taxpayers) than the rule in section 312(n)(4) on which it was supposed to be based. And the final regulations significantly simplified the calculation of the ACE LIFO adjustment (and reduced government revenues) by completely eliminating the "baseline LIFO recapture limitation."

/3/ K. Probst, D. Fullerton, R. Litan & P. Portney, "Footing the Bill for Superfund Cleanups," 54-90 (1995). The study's estimate of administrative and compliance costs is based on a survey of 365 corporations by Joel Slemrod and Marsha Blumenthal.

/4/ Our policy is to disclose when our column focuses on an issue in which one of us had significant involvement

at Treasury, or to which one of us has devoted significant attention on behalf of clients. In this case, we both practice in the AMT area, and one or both of us were involved in writing each of the AMT regulations discussed in the column. We hope that the column does not appear unduly hard or soft on these regulations.

*Editor's Note:* On Thursday, March 9, Ways and Means Committee Chairman Archer proposed to repeal the corporate AMT (but not the individual AMT) for tax years beginning after December 31, 2000. Although changes are proposed for various tax preference items, the separate and parallel system concept would remain in place for all taxpayers through the year 2000, and for individuals after that. See related news story on p. 1583.

END OF FOOTNOTES

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