Improved Development of Complex Tax Legislation

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The papers delivered at this conference cover key facets of the tax legislative process. This is an important subject, not only for tax professionals, but for all taxpayers. Furthermore, the tax legislative process has important consequences for the American economy. Therefore, it is appropriate that we should study in detail the process by which we develop and enact our tax legislation.

In addition to the papers presented at this conference, the tax legislative process and the product of that legislative process has been the subject of other papers and studies.[1] Certain of the papers presented at the joint conference presented by the American Institute of Certified Public Accountants and the Tax Section of the American Bar Association in January 1990 are particularly relevant.[2] While there will inevitably be some overlap in the subjects presented by others, both at this conference and in earlier papers, with some of the material presented in this Paper, this Paper addresses a specific subject that has not been the subject of independent attention but is of considerable importance in the development of sound tax legislation, sound tax policy, and sound tax administration. The specific subject of this Paper is improved development of complex tax legislation.

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1. Bittker, *Tax Reform—Yesterday, Today, and Tomorrow*, 44 WASH. & LEE L. REV. 11 (1987); Federal Bar Ass'n, *The Condition of the Tax Legislative Process*, 39 TAX NOTES 1581 (1988); Leonard, *Perspectives on the Tax Legislative Process*, 38 TAX NOTES 969 (1988); Reese, *The Politics of Tax Reform*, 32 NAT'L TAX J. 248 (1979); Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972); Rudder, *Fiscal Responsibility, Fairness, and the Revenue Committees*, *in* CONGRESS RECONSIDERED 225 (L. Dodd & B. Oppenheimer eds., 4th ed., 1989); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX (1985).

2. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS TAX DIVISION AND THE AMERICAN BAR ASSOCIATIONN SECTION OF TAXATION, PROCEEDINGS OF THE INVITATIONAL CONFERENCE ON REDUCTION OF TAX COMPLEXITY (1990); see in particular the papers of Bernard M. Shapiro, *Complexity in the Tax Legislative Process*, I-J-1, and John E. Chapoton, *The Role of the Treasury Department in Reducing Tax Complexity*, I-D-1.

While this Paper will address various aspects of complex tax legislation, its primary focus necessarily will be to analyze the meaning and cause of complex tax legislation and then to evaluate the efficacy of complex tax legislation. We should start by considering the state of complex tax legislation and then turn to the substance of this Paper, which is what can be done to improve the development of complex tax legislation.

I. Degree of Complexity in Present Tax Legislation

The initial reaction of most persons who undertake to study or define complexity in the present United States federal tax legislation is to focus on the scope and volume of this legislation. Federal tax legislation is principally, but not exclusively,[3] found in the Internal Revenue Code which is Title 26 of the United States Code.[4] Federal tax laws are of course not limited to the federal income tax but include employment taxes, excise taxes, transfer taxes, and certain other taxes.[5] While this Paper focuses primarily on the federal income tax, the principles developed in this Paper and the conclusions presented should be basically applicable to these other federal taxes.

Considering only the Internal Revenue Code, the growth over the years in the legislative volume addressing the federal tax laws has been overwhelming and could more aptly be described as mind boggling. If one starts with the initial American federal income tax act, one looks to the Civil War legislation in 1863, 1864, and 1865 which adopted the first income tax laws at the federal level.[6] That legislation required approximately two pages; whereas the 1986 in-

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3. Effective date provisions and many substantive provisions are not found in the Internal Revenue Code. *See, e.g.,* the so-called "Gallo exemption" to the generation-skipping transfer tax, Pub. L. No. 99-514, § 1433(b)(3), 100 Stat. 2085, 2731.

4. Unless otherwise indicated, all citations are to the Internal Revenue Code of 1986 in its current form.

5. The Internal Revenue Code is divided into eight subtitles:
Subtitle A - Income Taxes
Subtitle B - Estate & Gift Taxes
Subtitle C - Employment Taxes
Subtitle D - Miscellaneous Excise Taxes
Subtitle E - Alcohol, Tobacco and Certain Other Excise Taxes
Subtitle F - Procedure and Administration
Subtitle G - The Joint Committee on Taxation
Subtitle H - Financing of Presidential Election Campaigns
Subtitle I - Trust Fund Code

6. Act of June 30, 1864, ch. 173, 13 Stat. 223 (1864), as amended by Act of March 3, 1865, ch. 78, 13 Stat. 469, 479-81 (1865).

come tax code required approximately 509 pages.[7] The 1991 version of the income tax code as printed in the Prentice-Hall loose-leaf service requires 1,662 pages.

Even if one starts with the first income tax under the Sixteenth Amendment, that law required 15 pages.[8] The income tax provisions of the Internal Revenue Code of 1939 covered 22 pages.[9] The Internal Revenue Code of 1954, as originally enacted, covered 367 pages.[10] Thus, the sheer size of American federal tax laws has increased astronomically with a growth curve that would make the greatest growth industries envious.

Illustrations of the resulting complexity from this explosion in tax legislation are legion. Both humorists and serious critics can cite several subsections of Internal Revenue Code that contain many more words than the entirety of Lincoln's Gettysburg address.[11]

With this enormous growth in the volume of the federal income tax legislation, there has also been a parallel growth in the intrinsic complexity of this legislation. Many sections of the Internal Revenue Code are not fully understood by even the most serious students of these sections.[12] In some cases this has led taxpayers, tax advisors and tax administrators to just ignore certain provisions.[13]

Not only is tax legislation much more complex than it used to be, but the degree of complexity has grown when compared with other major areas of federal legislation. When compared with other major areas of federal legislation such as antitrust laws, labor law, securities laws, and banking laws, the complexity of federal tax leg-

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7. All page length numbers are based on the standard printings by the U.S. Government Printing Office and refer only to income tax provisions.

8. Revenue Act of 1913, ch. 16, 38 Stat. 114, 166-181 (1913).

9. Revenue Act of 1939, ch. 247, 53 Stat. 862 (1939).

10. Internal Revenue Code of 1954, ch. 736, 68A Stat. 3 (1954).

11. To cite only a few examples, *see* I.R..C §§ 108(e), 341(e), 338(h), 404(a), and 904(d). Several subsections contain a single sentence that is longer than the Gettysburg address. *See, e.g.*, section 341(e)(1).

12. By way of dramatizing this point, former Assistant Secretary of Treasury, Donald C. Lubick, asserted that section 341 (collapsible corporations) did not apply in Buffalo (his hometown) because taxpayers, tax professionals, and tax administrators in Buffalo could not understand the provision, so all ignored it. Fortunately, the Tax Reform Act of 1986 (at least prior to OBRA 1990) made section 341 largely inapplicable for everyone.

13. Leaders of tax departments of major multinational corporations and National Office representatives of the Internal Revenue Service have made such statements about section 904(d). Many other Code provisions can be cited for this point such as section 988 and the recently repealed estate tax provision in section 2036(c).

islation has increased disproportionately in comparison with these other major areas of federal legislation.[14] In contrast, in some areas such as deregulated industries including railroads, trucking, airlines and communication, applicable federal legislation has become considerably less complex. Probably the only area of federal legislation that has experienced anything comparable to federal tax legislation in increasing complexity would be environmental law, which is a relatively new area of federal legislation.[15]

II. The Role of Frequent Changes in the Complexity of Federal Tax Legislation

The second major cause of complexity in present federal tax legislation is the frequency with which there have been amendments and additions to this federal tax legislation. While the rate of change may have reached its zenith in the decade of 1981 through 1990, the frequency and scope of tax legislation in each of the two preceding decades was also substantial.[16]

During the decade of 1981 through 1990, there were eight major tax bills enacted as well as several other tax bills. The federal income tax legislation of this decade is as follows:

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14. For example, the Fourth Supplement to the second edition of *Morris, The Developing Labor Law*, which covers the years 1982-1987, states that there have been no changes or developments in labor law since the publication of the second edition in 1982. 1 Morris, The Developing Labor Law (2d ed. 4th Supp. 1987).

15. According to the Environment Reporter, there have been 179 environment related acts and executive orders since the first act in 1899. Of these 179 acts and orders, 152 have occurred in the 1970s and 1980s. 1 Env't Rep. (BNA).

16. In fact, a recently released study lists 37 separate significant federal tax acts since the enactment of the Internal Revenue Code of 1954. By decades these significant acts are divided as follows:

Decade	No. of Significant Acts
1950s	7
1960s	16
1970s	5
1980s and 1990	9

However, the scope and importance of the tax legislation between 1981 and 1990 outweighs the scope and importance of even the more numerous acts of the 1960s. Congressional Research Service, Taxes: Significant Federal Tax Acts, 1954-1990 (Mar. 4, 1991).

Economic Recovery Tax Act of 1981	August 13, 1981	Public law 97-34
Tax Equity and Fiscal Responsibility Act of 1982	September 3, 1982	Public Law 97-248
Deficit Reduction Act of 1984	July 18, 1984	Public Law 98-369
Tax Reform Act of 1986	October 22, 1986	Public Law 99-514
Omnibus Budget Reconciliation Act of 1987	December 22, 1987	Public Law 100-203
Technical and Miscellaneous Revenue Act of 1988	November 10, 1988	Public Law 100-647
Revenue Reconciliation Act of 1989	December 19, 1989	Public Law 101-239
Revenue Reconciliation Act of 1990	November 5, 1990	Public Law 101-508

While simply listing this legislation and the number of pages that the legislation covers presents some sense of the dimension of this tax legislation and gives some suggestion of the complexity that has followed from these frequent changes, it fails to convey the true scope and importance of the complex tax legislation in the past decade. Included within these multiple enactments are extraordinarily complicated provisions that have not previously been in the Code,[17] provisions which totally altered existing provisions of the Code,[18] and provisions which reversed or substantially modified provisions that had themselves been introduced during this decade.[19]

These two principal factors, that is the volume and the frequency of change in tax legislation, have almost overwhelmed the federal tax system. It is difficult to think of any legislative regime anywhere in the world that has produced complexity comparable

17. For example, I.R.C. §§ 1272-1278 and 461(h)(dealing with the time value of money) and I.R.C. § 263A (dealing with the capitalization and inclusion in inventory costs of certain expenses).

18. *See, e.g.*, I.R.C. §§ 1291-1297 (passive foreign investment companies) and 163(h).

19. Compare the 1981 Act rules for depreciation with the present provisions of sections 167 and 168, and, in the transfer tax, the replacement of section 2036(c) with Chapter 14.

to American federal income tax legislation.

III. Causes of this Volume and Frequency of Tax Legislation and the Resulting Complexity of Tax Legislation

The complexity of federal income tax legislation is not a matter of caprice or even misguided action by legislators; rather it is the predictable result of various economic, political, and social factors. These factors are well known to all who are involved with this process and all that is required in this Paper is a succinct listing of the principal factors.

A. THE NEED OF THE TAX SYSTEM TO RESPOND TO COMPLEX ECONOMIC DEVELOPMENTS

In every area of the Internal Revenue Code there are illustrative provisions that address the evolving complexity of our economy.[20]

B. THE NEED TO RAISE REVENUE

While revenue can be raised directly by increasing rates without the need for complex tax legislation,[21] it is frequently preferable for political, economic, or social reasons to raise revenue by expanding the tax base[22] rather than by increasing rates.[23]

C. THE DESIRE TO ADDRESS MANY SOCIAL AND POLITICAL PROBLEMS THROUGH TAX POLICY RATHER THAN BY DIRECT EXPENDITURES

This factor has always played a significant role in the complexity of the tax laws and the importance of this role continually increased, at least until the enactment of the Internal Revenue Code of 1986.[24] Almost every conceivable issue within the range of concern to the federal government is addressed to some degree

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20. *See, e.g.*, I.R.C. §§ 988, 404A and 904(g); *see also* I.R.C. § 368(a)(2)(D), (E), and (F).

21. But high marginal tax rates may cause transactional complexity that is more serious than complex tax legislation. See discussion *infra* text accompanying notes 48-52.

22. *See, e.g.*, I.R.C. §§ 263A, 67, and 163(h), and the repeal of the investment tax credit.

23. This, of course, was the underlying philosophy of the Tax Reform Act of 1986.

24. In broadening the tax base, the 1986 Act eliminated or narrowed many such provisions, such as the investment tax credit and the limitation on the deduction of personal interest expenses.

under the Internal Revenue Code.[25] This distinguishes the tax law from other areas of federal legislation and adds substantially to both the volume and the complexity of the tax laws.

D. PERIODIC REALLOCATION OF THE TAX BURDEN AMONG GROUPS OF TAXPAYERS

The tax burden can be allocated or reallocated among individual taxpayers to some degree at least by changes in progressive tax brackets. However, often the changes are made by more subtle and consequently more complicated patterns.[26] Furthermore, periodically there are changes in the allocation of tax burdens between corporate taxpayers and noncorporate taxpayers. For example, the 1981 Act tended to shift tax burden from corporations to noncorporate taxpayers; whereas the 1986 Act had the opposite goal.[27]

E. THE RESPONSE TO TAX AVOIDANCE SCHEMES AND ARRANGEMENTS

The interrelationship between the taxpayers' effort to avoid taxes and the government's efforts to raise revenue causes a "point-counterpoint" relationship that leads in whirlpool fashion to the tax complexity. As new legislation is enacted, tax advisors and their clients inevitably develop some programs to avoid the legislative purpose of such enacted tax legislation. In due course this leads the legislature to amend the earlier legislation or to introduce entirely new provisions to address this tax avoidance.[28] The process seems to be almost endless in the absence of some major restructuring of the tax laws.[29]

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25. A high percentage of the provisions in the Code are for non-revenue purposes; for only a limited sampling, *see* I.R.C. §§ 41, 42, 103, 121, 170, 175, and 6096.

26. A classic illustration is the alternative minimum tax, I.R.C. §§ 55-59.

27. Revenue estimates from the 1986 Act showed a revenue decrease of $121,947,000 for individuals and a $120,300,000 increase from corporations for 1987-1991. STAFF OF JOINT COMMITTEE ON TAXATION, 99TH CONG., 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 Appendix at 1353 (1987).

28. *See, e.g.*, I.R.C. §§ 382 and 383 (limitations on carryovers in corporate acquisitions).

29. The investment tax credits and the minimum distribution provisions for controlled foreign corporations were two illustrations of spiraling complexity which was ended by their repeal.

F. THE NEED TO BALANCE AND COMPROMISE THE COMPETING INTERESTS OF DIFFERENT CONSTITUENCIES

Numerous sections of the Internal Revenue Code are based on general rules with numerous exceptions, limitations, qualifications, and definitions.[30] In most cases these qualifications, exceptions, limitations, and definitions arise from the need to compromise the competing interests of raising revenue, tax equity, and the political positions of the innumerable groups that are concerned with the relevant tax issue.[31]

G. EXPANDING CONGRESSIONAL STAFFS AND OTHER STRUCTURAL CHANGES

In the opinion of several commentators, the factors identified by Mr. Shapiro such as staff expansion and the declining authority of the chairmen of the tax-writing committees are the principal reason for increasing complex tax legislation.[32]

H. THE SEARCH FOR THE THEORETICALLY CORRECT APPROACH

Finally, but less frequently cited, is the striving for theoretical improvements and perfection. Rarely is this factor the only influence in producing complex tax legislation, but it frequently plays a significant role in that consequence. This search for the theoretically correct approach is itself caused by various factors,[33] *e.g.*, the roles of academics and Congressional and Treasury staffs. Section 338 is a classic example of how the search for theoretical perfection by staff, consultants, and academics has produced complexity enormously in excess of any evil it was intended to remedy.[34]

IV. RESPONSE TO FACTORS CAUSING COMPLEX TAX LEGISLATION

Assuming the factors listed above are the principal elements in producing complex tax legislation, one might conclude that the principal method of improving complex tax legislation would be to

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30. There are innumerable examples, such as I.R.C. §§ 404, 404A, 163, and 7701(b).
31. Section 163(h) is one of many good illustrations.
32. Shapiro, *supra* note 2, at I-J-15 to I-J-30.
33. This is discussed in detail in Shapiro, *supra* note 2.
34. Seven pages of legislation and more than one hundred pages of regulations for a provision that is mainly a trap for the unwary. Furthermore, the repeal of *General Utilities* has greatly reduced whatever justification there was for this provision.

eliminate or reduce the importance of these factors in developing future tax policy and future tax legislation. In my judgment, however, it is unrealistic to expect that the importance of any of these factors, with one possible exception, can be diminished, much less eliminated. Each of these factors is far too important to the American economic and political system to anticipate that it will be sacrificed, or even diminished in any significant degree, in order to accomplish the goal of reducing complex tax legislation.[35]

This view that the causes of complex tax legislation are largely immutable, if correct, seems to produce a dreary conclusion. If complex tax legislation is the product of factors that cannot be eliminated and even significantly decreased, this seems to lead to the conclusion that ever increasing tax complexity is the wave of the future as well as the way of the past. However, being both an optimist and an advocate of tax simplification, I believe that there are means by which complex tax legislation can be amended and improved within the limitations of these factors that give rise to this complexity.[36] The balance of this Paper will analyze this possibility.

V. Improved Opportunity for Reform of Complex Tax Legislation

It is worth pausing in this analysis to note the three components stated by Mr. Shapiro in his paper[37] as the requirements for developing a momentum that could lead to meaningful simplification of tax legislation. Just a little over a year ago Mr. Shapiro stated that there would need to be: (1) the elimination or reduction in the pressure for tax legislation driven by the need to increase revenue; (2) because of the absence of a vocal constituency for tax simplification, Congress would have to take the lead; and (3) the time pressure in which tax legislation was being enacted would have to be slowed. Mr. Shapiro's remarks have proved to be prescient in a remarkably short time period, principally as a result of the Budget Reconciliation Act of 1990 which provides a promised five-year budget reconciliation. There is now a "window of oppor-

35. The possible exception is the striving for theoretical perfection. Perhaps we have learned enough from the experience with the efforts to produce theoretical improvements to appreciate that in many cases these efforts are quite often unproductive.

36. The proposition that some complex tax legislation is desirable in accomplishing net simplicity is discussed *infra* text accompanying notes 48-52.

37. Shapiro, *supra* note 2, at I-J-31.

tunity" for some modest improvements, but the causes of complexity remain extant and the question of how to improve complex tax legislation remains unanswered.

VI. Adoption of an Entirely New Tax Regime in Lieu of the Federal Income Tax

The most straightforward way to eliminate present complex tax legislation is to replace our present federal income tax laws and substitute an alternative tax to raise equivalent revenues. However, the desire to simplify federal tax legislation will never rise to a level of importance where the drive for the reduction in tax complexity is the sole or even the primary cause for the adoption of an entirely new taxing regime.

There are alternative tax paradigms which are receiving serious attention and considerable support, but these proposals for a fundamental new taxing regime are not importantly motivated by any desire to simplify the tax law but rather by entirely separate political and social forces. While such regimes would not be adopted solely to eliminate complex tax legislation, the elimination of complex tax legislation could be the incidental result of the adoption of such a new regime.

The most promising of these possibilities, if one wishes to so regard it, would be if the United States were to follow the pattern of most developed countries by adopting a value added tax, and to do so as a substitute for the federal income tax.[38] It seems axiomatic that, if the value added tax were to be adopted in addition to the federal income tax, we would move towards an even more complex tax regime no matter how straightforward the value added tax might be in its initial form.[39]

The purposes of this Paper is not to discuss the value added tax, which has been extensively discussed in innumerable well thought-out presentations.[40] Its adoption by all of the major indus-

38. Where a value added tax has been adopted in other countries, it has been in addition to and not in lieu of an income tax.

39. It can be fairly argued that a VAT and a continued federal income tax with a broader base and lower rates than under present law would produce a net reduction in tax complexity, but this is not my position.

40. A special committee on the value added tax of the Section of Taxation of the American Bar Association has published a five-part series on the VAT appearing in *The Tax Lawyer* as follows: *Report of the Special Subcommittee of the Committee on General Income Tax Problems on the Value-Added Tax*, 24 Tax Law. 419 (1971); *Should the United States Adopt the Value-Added Tax?—A Survey of the Policy Considerations and*

trial companies of the world in one form or another and its importance to equalizing our international trade position with those countries, as well as its enormous revenue raising potential, has led many thoughtful commentators either to urge its adoption or to conclude that the adoption of the value added tax must inevitably follow.[41]

Without reaching any conclusions on the merits of a value added tax for the United States, it is necessary to recognize that there is an important theoretical and political opposition to any such new regime. The opposition includes forces on the right who are concerned about the additional amount of revenue that could be raised by a value added tax and the resulting resources that tax would provide for governmental expenditures. Opposition on the left comes from those who are concerned that the relatively progressive federal income tax will be replaced with a relatively regressive value added tax. States and local governments have opposed the value added tax because they consider it as a threat to one of their principal revenue sources, the sales tax. Added to these problems are the fears that a value added tax would cause substantial inflation.

While each of these major reasons for opposition to a value added tax can be addressed and perhaps even satisfied, this will not be an easy task. Considering these major objections to a value added tax and innumerable other factors that need not be discussed in this Paper, one can hardly look in the short run to the value added tax as a means of solving the complexity in existing federal income tax legislation. Finally, it should be noted that many serious students of the value added tax raise considerable concerns about the complexity that would come with this new tax regime.[42]

A similar and less recognized possibility, but perhaps also less

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the Data Base, 26 TAX LAW. 45 (1972); *Evaluation of an Additive Method, Value-Added Tax for Use in the United States*, 30 TAX LAW. 565 (1977); *The Choice Between Value-Added and Sales Taxation at Federal and State Levels in the United States*, 29 TAX LAW. 457 (1976); and *Technical Problems in Designing a Broad-Based Value-Added Tax for the United States*, 28 TAX LAW. 1983 (1975). *See also* McLure, *A Federal Tax on Value Added: U.S. View*, 66 PROC. NAT'L TAX ASS'N-TAX INST. AM. 96 (1973); Bickley, *The Value-Added Tax: Concepts, Issues and Experience*, 47 TAX NOTES 447 (1990); Turnier, *Designing an Efficient Value Added Tax*, 39 TAX L. REV. 435 (1984); U.S. DEPARTMENT OF TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY AND ECONOMIC GROWTH, Volume 3 Value-Added Tax (1984).

41. *See, e.g.*, Smith, *Value-Added Tax: The Case For*, 48 HARV. BUS. REV. 77 (1970).

42. *See supra* note 40.

controversial, is the business transfer tax proposal that was introduced by Senator Roth in 1985.[43] While this proposal is closely related to a credit-type value added tax, it has some significant differences.[44] Again, it seems unlikely that this proposal would be adopted at any time in the foreseeable future and, furthermore, it is far from clear that, if this proposal were adopted, it would be in lieu of the federal income tax, although it might be in lieu of the federal corporate income tax.

A separate and distinct alternative to either the present income tax system or a value added tax regime is the consumption income tax. This was presented in the 1977 Treasury proposals for tax reform[45] and has been analyzed by several distinguished scholars of our tax laws.[46]

The final regime that should be mentioned is an integration of the corporate and shareholder tax. This has been the subject of many studies and is currently being studied in depth by the Treasury Department, and that study is scheduled to be released before the end of 1991.

Without reaching any conclusions in this Paper on the merits of these or any other alternative regime, it is probably unrealistic to expect any one of them to play a significant role at any time in this century in the elimination or even reduction in complex tax legislation. Consequently, we are left with the very difficult assignment of coming up with solutions to this problem in the framework of the present tax regime and with the realization, as stated above, that the factors that give rise to complex tax legislation cannot be eliminated and probably cannot even be significantly decreased.

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43. S. 1102, 99th Cong. 1st Sess. (1985); *see also* the similar proposal presented by Congressman Richard Schulze (R-Pa), a member of the Ways and Means Committee, in his press release of July 12, 1990.

44. The Business Transfer Tax (BTT) is imposed on the excess of business receipts over business expenses, as opposed to the value added, but is generally considered to be a subtraction-type value added tax.

45. U.S. DEPARTMENT OF TREASURY, BLUEPRINTS FOR BASIC TAX REFORM, Ch. 4, A Model Cash Flow Tax (1977).

46. A partial list would include the following: Committee on Simplification, ABA Section of Taxation, *Complexity and the Personal Consumption Tax*, 35 TAX LAW. 415 (1982); Bradford, *What are Consumption Taxes and Who Pays Them?* in THE CONSUMPTION TAX: A BETTER ALTERNATIVE? (C. Walker & M. Bloomfield eds. 1987), *reprinted in* 39 TAX NOTES 383 (1988); Andrews, *A Consumption-type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425 (1985); Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979); Warren, *Would a Consumption Tax be Fairer than an Income Tax?*, 89 YALE L.J. 1081 (1980).

VII. Extent to Which Complex Tax Legislation Poses Practical Problems

Addressing issues of complex tax legislation within the existing framework of the federal income tax legislation, one must first determine to what extent complex tax legislation is a negative. The response that complex tax legislative provisions are per se undesirable and that we should always seek to return to a simpler and more understandable tax legislation is overly simplistic. In many situations highly complex statutory provisions can and have produced practical simplicity in the tax law. Taxpayers rarely, if ever, need to read the statutory provisions of the Internal Revenue Code. Consequently, a complex piece of tax legislation is not per se complicating for taxpayers. If the legislation produces clear and understandable results that can be presented clearly on a tax return or in accompanying instructions, it really is of no consequence that this result comes about from a very complex legislative provision.[47]

It is much more important that tax legislation produce transactional, planning, and administrative simplicity even if this requires complex tax legislation. Highly complex legislation can produce significant and important simplification if the consequence of it is to discourage taxpayers from engaging in complicated and uneconomical transactions to minimize or avoid tax. While not all will agree,[48] the provisions of section 469,[49] although admittedly extremely complicated,[50] have effectively shut down the most pervasive forms of tax shelters that were thriving during the 1960s, the 1970s and the first half of the 1980s. These tax shelters engendered an entire industry and resulted in enormous complications, costs, and controversy in transactional planning, tax return positions, Service audits and litigation. These controversies consumed the Service, the Tax Court, and large numbers of taxpayers for

47. The present statutory provisions for depreciation under section 167 and section 168 are enormously complicated as legislation but in most circumstances the legislation produces a clear and understandable result that does not present problems for taxpayers, tax professionals, or administrators.

48. Compare Stanley A. Koppelman, *At Risk and Passive Activity Limitations; Should Complexity be Reduced* and the comments on this paper by Sally M. Jones and Stefan F. Tucker in Proceedings of the Invitational Conference on Reduction of Tax Complexity, *supra* note 2, at I-P-1, I-Q-1, and I-R-1, respectively.

49. Section 465 and certain other provisions reinforce section 469 in achieving this result.

50. Mr. Tucker notes that section 469 and the regulations under it, together with related material, require 1,517 pages. *See* Tucker, *supra* note 2, at I-R-2.

many years. As we complete the phase-out of the pre-1986 rules and section 469 comes into full force and effect, it is showing itself to be very effective in producing transactional and tax return simplicity when compared with the situation that existed before its adoption.[51]

Thus, it is first necessary to determine whether a particular provision of complex tax legislation is, on balance, producing simplicity, either because its application can be readily understood by taxpayers and tax administrators or because it results in substantial reduction in complex planning and administration.[52] Nevertheless, the majority of complex tax provisions cannot be said to fall into either of these categories and it is here we should address our efforts to improve complex tax legislation.

VIII. Legislative Alternatives in Addressing Complex Situations

We are now at the "bottom line" of this subject matter. The principal sources of complex tax legislation have been identified. While we may now have a "window of opportunity," my operating assumption is that the causes of complex tax legislation are basically intractable. Furthermore, it seems unlikely that the value added tax or any other alternative tax regime to the federal income tax will be adopted within the foreseeable future as a substitute for the federal income tax. If these conclusions are correct, then we must seek to improve complex tax legislation within the existing system and with awareness that the root causes of complex tax legislation are almost immutable. Nevertheless, the situation is not hopeless.

In translating any tax legislative policy that involves a subject matter of any complexity into legislative language, there are four drafting alternatives. While each of these alternatives shades into another at the margins, it is useful to consider them as separate and distinct alternatives. These legislative drafting alternatives

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51. Mr. Tucker suggests that section 469 should blow away in the sand of time, much as the massive statute of Ozymandias, king of kings. *See* Tucker, *supra* note 2, at I-R-2 to I-R-3. At least to date, it has been the colossus of the tax shelter industry that is blowing away in the sand. With the end of the five-year transition period, few taxpayers will be troubled by the complexity of section 469 and its massive regulations and yet the passive activity loss rules will have eliminated what had been one of the most, if not *the* most, complicating aspect of pre-1986 tax planning.

52. For another example of a complex legislative provision that has brought simplicity, see section 7701(b) (definition of resident alien).

are:

(a) complex tax legislation which seeks to address the matter essentially through the legislative language itself without any major reliance on regulations;[53]
(b) complex tax legislation that also delegates broad regulatory authority to supplement the legislation;[54]
(c) relatively simple legislation that primarily looks to regulations to address the matter;[55] and
(d) relatively simple legislation that sets forth broad standards and does not look primarily to regulations for implementation, but rather looks to resolution on a case-by-case basis.[56]

The trend in recent legislation and throughout this past decade has been to look to either of the first two possibilities as the principal legislative response.[57] Theoretically there is much to be said for preferring either of these two approaches. It should be the legislature that determines tax policy and, therefore, the first alternative of relying on detailed statutory language is most consistent with this political responsibility. Nevertheless, a full and detailed legislative solution is not only enormously complicating, but it allows taxpayers to develop schemes and plans to avoid the legislative purpose when that purpose is set forth in precise and detailed statutory language. This, in turn, as noted above, leads to further legislative responses. We have seen a great deal of this within recent years.[58] Because such legislation is necessarily complicated and detailed, it is normally very difficult for taxpayers, their advisors and tax administrators to understand and implement such legislation. Such complex tax legislation presents taxpayers, tax professionals, and tax administrators with enormous compliance problems and not infrequently leads to a general disregard and disrespect for such legislation.[59]

Much the same points can be made with regard to the second alternative, which looks to detailed legislative language and also to

53. *See, e.g.*, I.R.C. § 163(h) (limitation on the deduction of interest).

54. *See, e.g.*, I.R.C. § 864(e) (allocation of interest and other expenses to foreign source income).

55. *See, e.g.*, I.R.C. § 385 (debt versus equity).

56. *See, e.g.*, I.R.C § 263(a) (capitalization of certain expenditures).

57. It is difficult to identify areas of complexity that have been addressed by either the third or fourth alternatives within the past decade.

58. To note only one area, consider the legislative repeal of the *General Utilities* principle and the resulting need for corrective and anti-abuse provisions.

59. As noted previously, section 904(d) is a good illustration. *See supra* notes 12 and 13 and accompanying text.

legislative or administrative regulations to implement such legislation. While it can be said that this approach provides a flexibility not existing in the first alternative in that it allows the Treasury Department to address points not foreseen at the time of the enactment of the legislation, it, unfortunately, often has the result of producing the worst of both worlds as regards complexity. There is not only the complexity of the tax legislation but also the complexity of the regulations.[60] Furthermore, the delay in the issuance of proposed regulations, and then the extended period between the issuance of such proposed regulations and the issuance of final regulations add further significant complications and uncertainties.[61]

The third alternative is to enact relatively simple tax legislation, which leaves the Treasury Department with authority to issue legislative regulations. Again this has much to be said for it in theory but has not proved to be too useful in practice. Certainly the classic illustration of the unsuccessful use of this third approach is section 385. This important issue of distinguishing debt from equity has been left unresolved after three separate unsuccessful efforts by the Treasury Department.[62] Furthermore, as a matter of division of responsibility under the Constitution, there is question as to the extent that Congress should delegate its legislative responsibilities to the executive branch.

This leads me to the fourth alternative: relatively broad-based and simple legislation that does not look primarily to legislative regulations to flesh out the legislation but rather to interpretation on a case-by-case basis through litigation, revenue rulings, or other similar authority. Whether or not for conscious reasons, this fourth alternative seems to have fallen into disfavor; there are relatively few illustrations of it in tax legislation during the past decade.

Some of the earlier enacted key provisions of the Code fall into this fourth legislative drafting alternative. While some may disagree with my categorization of them, I include in this fourth

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60. *See, e.g.*, I.R.C §§ 338, 382, and 964(e) and the regulations under those sections.

61. *See, e.g.*, the situation under section 404A where proposed regulations were issued on April 8, 1985, which were immediately shown to be defective. To date, the Treasury Department has neither issued new proposed regulations nor final regulations. As a consequence, this provision is in limbo and so are taxpayers with pending issues under section 404A.

62. The first version of the section 385 regulations was issued in 1980, to be effective on May 1, 1981. These regulations were amended first by T.D. 7774, 1981-1 C.B. 168, second by T.D. 7801, 1982-1 C.B. 60, and third by T.D. 7822, 1982-2 C.B. 84. The Treasury ultimately withdrew the regulations in 1983. T.D. 7920, 1983-2 C.B. 69.

drafting alternative section 61,[63] section 162(a), section 263(a), section 269, and section 482. The combination of section 61, section 162(a), and section 263(a) can be fairly and accurately described as three of the most important provisions in the Code—some may say the three most important together with the rate provisions of sections 1 and 11. Each of these provisions has been in the present Code and its predecessors for decades without significant legislative change. The regulations under these provisions are relatively short and understandable; with few exceptions they do not add materially to the general rules established by these statutory provisions. Yet these three sections successfully address the key questions of the federal income tax system: what is gross income; what are deductible business expenses[64] in reaching taxable income, and what expenditures must be capitalized. Many major issues are left unanswered by these statutory provisions, as they necessarily will be by this fourth drafting alternative, but these issues have been addressed on a case-by-case basis.[65] These provisions work; taxpayers, tax professionals, and tax administrators alike can and do understand and implement these provisions. They lack precision, but that is a strength, not a weakness.

Section 269 and section 482 are also from this fourth statutory drafting alternative.[66] They differ, however, in that these provisions are anti-avoidance provisions; the mortar between bricks such as sections 61, 162(a), and 263(a).

While each of these four alternatives has its appropriate uses, this fourth approach offers the greatest prospect for improvement in complex tax legislation. While the details are beyond the scope

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63. While there are numerous sections of the Code providing specific inclusions in (I.R.C. §§ 71-90) and specific exclusions from (I.R.C §§ 101-136) gross income, the basic issues of what constitutes gross income are encompassed in the nine words, "gross income means all income from whatever source derived . . . ." Congress left the development of the parameters of this provision to the courts.

64. Section 212 supplements section 162 with respect to investment expenses.

65. *See, e.g.*, Eisner v. Macomber, 252 U.S. 189 (1920), United States v. Kirby Lumber Co., 284 U.S. 1 (1931), and C.I.R. v. Glenshaw Glass Co., 348 U.S. 426 (1955) interpreting the predecessors to I.R.C. § 61; Welch v. Helvering, 290 U.S. 111 (1933), Deputy v. Du Pont, 308 U.S. 488 (1940), and Higgins v. C.I.R., 312 U.S. 212 (1941), interpreting the predecessor to I.R.C. § 162(a); and Woodward v. C.I.R., 397 U.S. 572 (1970) and C.I.R. v. Idaho Power Co., 418 U.S. 1 (1974) interpreting I.R.C. § 263(a).

66. While there are now extensive regulations under section 482, which may soon be revised, for many years there were no detailed regulations under section 482 or its predecessor section 45 of Internal Revenue Code of 1939. Furthermore, it is highly debatable whether these regulations—particularly the pricing regulations—have been a boon or a bane.

of this Paper, it is quite possible that broad, readily understandable general legislation could replace the enormously complex tax legislation that threatens to overwhelm the federal income tax system. By combining broad general principles such as sections 61, 162(a), and 263(a) with general anti-avoidance rules such as sections 269 and 482, some of the most troublesome complexity could be greatly alleviated. This approach should be seriously considered as a substitute for such areas as the foreign tax credit limitation, the allocation of expenses to foreign source income, time value of money issues, loss and credit carryovers, and certain qualified employee benefits issues. While this would probably lead to a considerable gap in interpretation between taxpayers and tax administrators, this has always been true under section 263(a), but the two sides compromise these differences in practical and efficient means. Where necessary, major issues could be presented to the courts for resolution. Questions will arise whether the substitution of this fourth alternative for either the first or second alternative will lead to significant revenue gains or losses, but there is no reason why this should be the result, particularly if the legislative history makes clear that this is not intended.

I recommend a reconsideration of this now largely neglected alternative to complex tax legislation.

IX. Conclusion

There are no panaceas; but we can take practical steps to improve complex tax. First we must recognize that the causes of complex tax legislation are not likely to dissipate, so we must develop procedures to live with them. Second, we must analyze each particular issue to determine whether a complex legislative solution will be the better approach to accomplish simplification. Third, we must provide continuity which can best be accomplished by retaining and building upon the foundation of low tax rates and a broad tax base as established under the Tax Reform Act of 1986.[67] Finally, we must review the major area of legislative tax complexity to determine if detailed legislation and regulatory provisions cannot be sensibly and profitably replaced by legislation stated in broad policy principles with appropriate anti-avoidance provisions.

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67. Contrary to the statement of Professor Martin D. Ginsburg, the 1986 Act does belong in the "Pantheon of great tax legislation."