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reports in brief

edited by Robert J. Wells

Tax Complexity, Reform, and the Illusions of Tax Simplification

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The federal income tax progressively became more complicated in the decades following its introduction in 1913. However, during those first decades of the income tax, the tax laws evolved through a process of gradual and incremental adjustments to the original statute. The main effort was to find a workable definition of taxable "income" — a concept left for all practical purposes undefined in both the tax statutes and the Sixteenth Amendment to the U.S. Constitution. Following World War II, the development of the federal income tax entered a second phase during which the level of complexity of the tax laws increased dramatically. Thereafter, there was a virtual explosion in the complexity of the tax code, especially during the 1980s.[1] Most students of the tax laws would agree with the authors of one study, who simply concluded that: "The current U.S. income tax system is a nightmare of complexity."[2]

In light of the increasingly excessive and oppressive complexity of the income tax laws, tax simplification has emerged as one of the perennial themes in the academic tax literature. The U.S. Treasury Department, the staffs of congressional tax committees, and the tax bar have all devoted considerable time and effort to the question of tax simplification.[3] Indeed, there is a widespread tendency to equate tax "reform" per se with "simplification."[4] Many of these reform proposals are blatantly political, amounting to little more than empty platitudes that play well among constituents. For instance, the then-Chairmen of the House Ways and Means and Senate Finance Committees, Dan Rostenkowski and Lloyd Bentsen, picked up on the theme of tax simplification and introduced their own package of proposals in 1991.[5] Generally, these proposals make for good press, but fail to address the fundamental causes behind the rise in tax complexity. Few reformers demanding simplification of the tax laws recognize the inherent difficulties in their positions. Excess complexity is rooted in the very process by which U.S. tax policy is made. Some of the complexity is attributable to efforts by policymakers to accomplish too much through the tax laws, using the income tax code as the

[1]The income tax provisions of the Internal Revenue Code of 1954 contained 103 sections, while the Internal Revenue Code of 1986, as amended through 1993, contained 698 sections. It has been estimated that the volume of the income tax regulations increased 730 percent during the period from 1954-1994. There has been a similar explosion in "law" in other policy areas as well. For instance, Title II of the Social Security Act of 1935 was only four pages long when enacted, grew to 50 pages by 1950, and 200 pages by the 1970s. This did not even include new sections of the statute, such as Medicare.

[2]Alvin Rabushka and Robert E. Hall, *The Flat Tax* (Stanford: Hoover Institution Press, 1985), p. 5.

[3]U.S. Department of Treasury, Office of Tax Analysis, "Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President," printed in *Tax Notes*, Dec. 3, 1984, p. 873; Joint Comm. on Tax'n, 95th Cong., 1st Sess., *Issues in Simplification of the Income Tax Laws*, (Comm. Print 1977); Report of New York State Bar Association, prepared by Sidney I. Roberts, Wilbur H. Friedman, Martin D. Ginsburg, Carter T. Louthan, Donald C. Lubick, Milton Young and George E. Zeitlin, "A Report on Complexity and the Income Tax," printed in 27 *Tax L. Rev.* 325 (1972).

[4]*See, e.g.*, David Brockway, "The Process Behind Successful Tax Reform," 31 *Vill. L. Rev.* 1803, 1803 (1986) ("True tax reform will not be achieved unless there is significant simplification of code provision.").

[5]"Tax Simplification Act of 1991," S. 1394, H.R. 2777, 102d Cong., 1st Sess. (1991). Never enacted by Congress, another unsuccessful bill was subsequently reintroduced by Rostenkowski on November 1, 1993, as the "Tax Simplification and Technical Corrections Act of 1993," H.R. 3419.

vehicle for implementing so much public policy. Much of the complexity is attributable to prior reforms enacted in the pursuit of greater purity and equity in the tax laws. As Senator Russell Long once quipped: "The complexity of our code in the main is not there because of some mischief. Most of it is there in the effort to do more perfect justice."[6]

> ***Complexity does not enter the tax code so much out of malevolence as through misguided reform efforts and excessive demands made on the tax laws as the vehicle for implementing public policy.***

Thus, complexity does not enter the tax code so much out of malevolence as through misguided reform efforts and excessive demands made on the tax laws as the vehicle for implementing public policy. The causes behind excess complexity cannot be reduced to any single factor, and open-ended calls for "simplification" are invariably simplistic. To understand the underlying sources of tax complexity, it is necessary first to consider why the tax laws became ever more complex over time. In addition, it is important to understand just what is wrong with excessive complexity in the tax laws. Because tax lawyers earn their livelihood from such complexities, many will be reluctant to acknowledge that there is even a "problem" at all. Because members of Congress can help secure reelection by railing against tax complexity, which ultimately is the product of their own labors, legislative proposals for tax simplification are not a very promising source of illumination on the issue either.

This article considers the issue of excess complexity by examining the federal income tax from a broad historical perspective to understand how and why the tax system developed into such a complex legal edifice. Those trends in the policymaking process that have contributed most to the increase in tax complexity are identified. Much complexity in the tax laws is attributable to reforms enacted in the pursuit of ever greater purity in the tax laws. Many high-minded tax reform proposals end up as nightmares of complexity once translated into regulations by the tax experts in Treasury. In the wake of the success of tax reform efforts in the 1980s, it is apparent that many of the reform measures adopted by Congress and given effect through Treasury regulations are themselves the cause of much of the increased complexity in the federal income tax laws, such as the passive activity loss rules, which were aimed at eliminating tax shelters, the original issue discount (OID) rules, which were aimed at preventing tax avoidance through deferral of the payment of tax, and the infamous section 89 proposed regulations. These and other regulatory efforts were originally conceived of as reforms aimed at perceived "abuses" of the tax laws. They ended up increasing the complexity of the tax laws to the point of where they nearly become dysfunctional — that point at which taxpayers and the Service can no longer understand or apply the tax laws.

Thus, the source of much of the complexity in the tax laws can be located within the tax policymaking process itself, rather than in the external economic environment. For instance, Congress now attempts to implement more and more domestic policy through the tax code. The tendency of congressional policymakers to make use of "tax expenditures" is perhaps the single most significant source of complexity in our tax laws. By the 1960s, it was common practice for both Republicans and Democrats to use tax credits and preferences to implement social and economic policy. Because policymaking through tax expenditures is relatively easy and generally conducive to the political and electoral needs of representatives in Congress, it has become a common mode of congressional policymaking. As a result, the tax code is now overflowing with the many special tax preferences generated by the political process, and no end to the practice is in sight. Stanley Surrey and Paul McDaniel calculated that the amount of government "spending" through tax expenditures increased by 179 percent from fiscal year 1974 to fiscal year 1981.[7] A recent study by the General Accounting Office estimates that tax expenditures totaled almost $402 billion in 1993 and will continue to increase annually by 4 percent.[8]

The effort to write so much of domestic policy into the tax code requires tax policymakers to draw ever more subtle distinctions between those taxpayers and transactions intended to qualify for the related tax benefits and those who are perceived to be abusing these provisions. These distinctions inevitably translate into increasingly complicated rules and regulations. While tax reformists have attacked the use of tax expenditures to implement policy, congressmen find the use of tax expenditures highly conducive to satisfying their own needs as electoral creatures. Even the wholesale assault on tax expenditures launched through the Tax Reform Act of 1986 made only a dent in the complexity of the tax laws.

As Congress has relied more and more on tax preferences to make public policy, it also has been forced to adopt other reform measures (such as those that govern tax arbitrage and bond discount in original issues) precisely to close the "leaks" in the tax base and prevent the "abuses" attributable to overuse of such tax preferences. In such instances, tax policymakers can be seen as rectifying their own poor judgment and overgenerosity in enacting too many tax preferences in the first place. Charles McLure has referred to measures designed to limit the use of tax preferences

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[6]U.S. Senate, Finance Committee Hearings, *Tax Reform Proposals*, Vol. 3, 99th Cong., 2d Sess., p. 53.

[7]Surrey and McDaniel, *Tax Expenditures*, p. 6.

[8]General Accounting Office, (GAO/GGD-AIMD-94-122), "Tax Policy: Tax Expenditures Deserve More Scrutiny," (June 3, 1994).

as "back-stop" provisions intended to "prevent the abuse of tax preferences and/or the appearance of inequity. . . ."[9] Through back-stop reforms, the tax laws necessarily become more complicated as new provisions are introduced to limit the applicability of yesterday's tax preferences.[10] The incremental policymaking process that generates tax preferences is generally incapable of such a radical step as abandoning them altogether, even once they are denounced by the same policymakers as abusive. Incremental policymaking tends to produce only minor adjustments to existing tax policies, and back-stop reforms are highly compatible with such a mode of policymaking.

The tax code also has grown in complexity as policymakers and the tax experts in the Treasury Department have became more and more sophisticated in perfecting the underlying "economic" concepts of the income tax. This is especially the case with respect to purifying and refining the statutory definition of income. The federal income tax rests upon the concept of taxing income received or accrued during the taxable year. As the tax experts have become more adept at defining taxable income in economic terms, statutory provisions have become more complicated. Economic analysis has been introduced into the tax code to eradicate perceived abuses of the tax rules by those taxpayers who themselves understand how to manipulate economic concepts to their own advantage. The new "economic" provisions introduced in the 1980s contributed some of the most complicated rules to the tax code. For instance, the OID rules introduced an extraordinary level of complexity into the tax laws. Likewise, the campaign against "tax arbitrage" waged during the 1980s introduced additional complexity of the tax laws as new provisions were added to the tax laws to limit the ability of taxpayers to benefit from the tax preferences that generate arbitrage opportunities.

In the end, the reasons for tax simplification go beyond the difficulty of filling out tax returns and computing deductions. The current system of taxation has contributed much to the bureaucratization of modern life and the increased regulation of economic life, for individuals as well as businesses. Those who are unsympathetic to the problem of government over-regulation of business should recognize that an overly complex tax system also adversely affects individuals. The tax laws have a peculiar impact on private behavior insofar as they do not strictly prohibit particular private action or conduct, but rather establish a broad framework of incentives and disincentives through which private activity is subtly altered. The tax laws impose a superstructure above and beyond the legal framework that prevails under the liberal political tradition. Certain activity may be entirely "legal" in the sense that there are no prohibitions against such behavior. However, under the tax laws, such activity can carry a price — the burden of additional taxation. This creates a disincentive to carrying on one's business activities in that form just as surely as if there was an outright legal prohibition against such conduct. In this respect, the tax laws seem to be exempt from the traditional principles of the liberal political tradition — specifically, the rule of law. The rule of law assumes that there are clear legal standards, enunciated prior to taking effect, thereby providing citizens with notice of prohibited behavior and attaching sanctions to violations of such prohibitions. Fundamental to the concept of the rule of law is the notion that legal standards of public behavior be known, or at least knowable, by the citizenry. This was best expressed by James Madison in *The Federalist Papers*:

> It will be of little avail to the people, that the laws are made by men of their own choice, if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repealed or revised before they are promulgated, or undergo such incessant changes that no man, who knows what the law is today, can guess what it will be to-morrow. Law is defined to be a rule of action; but how can that be a rule, which is little known, and less fixed?"[11]

When the level of complexity of the law becomes so great that those who are subject to its sanctions cannot comprehend what it is that the law requires of them, then the rule of law has been abandoned as an operative principle.

This article concludes that to the extent that the tax laws are public laws that similarly should be governed by the principles of the rule of law, the excessive complexity of the law means that the legal standards enunciated thereunder cannot be comprehended by those subject to sanctions for a failure to comply. When then the level of complexity of the law becomes so great that those who are subject to its sanctions cannot comprehend what it is that the law requires of them, then the rule of law has been abandoned as an operative principle. In many respects this has become the sad state of tax policymaking as the tax code has become a massive and impenetrable edifice of rules and regulations that governs so much of economic life and business activity.

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[9] Charles A. McLure, Jr., "The Budget Process and Tax Simplification Complication," 45 *Tax L. Rev.* 25, 43 (1989).

[10] Some have suggested that the problem is "piggishness" in overusing tax preferences to reduce one's tax liabilities. *See* Daniel Shaviro, "Selective Limitations on Tax Benefits," 56 *U. Chi. L. Rev.* 1189 (1989). Determining when a taxpayer takes too much advantage of tax preferences is an entirely open question, and inevitably attempting to determine when a taxpayer has overused tax preferences results in one more set of complicated calculations with which taxpayers will be forced to confront.

[11] James Madison, *The Federalist Papers* (New York: New American Library, 1961 ed.), No. 62, p. 381.