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TAX COMPLEXITY, REFORM, AND THE ILLUSIONS OF TAX SIMPLIFICATION

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"[N]o one understands the Income Tax Law [the Revenue Act of 1913] except persons who have not sufficient intelligence to understand the questions that arise under it."

Senator Elihu Root of New York (1913)

"Simplicity in modern taxation is a problem of basic architectural design. Present legislation is insufferably complicated and nearly unintelligible. If it is not simplified, half of the population may have to become tax lawyers and tax accountants."

Henry C. Simons, *Federal Tax Reform* (1950)

"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."

Senator Russell Long, Former Chairman, Senate Finance Committee

INTRODUCTION

Inasmuch as only the rudimentary structure of a taxing scheme was laid out in the first income tax law, the Revenue Act of 1913,[1] the many details required to give concrete meaning to the statute were left to be filled in over subsequent decades. Accordingly, the newly imposed federal income tax progressively became more complicated during its first decades as it evolved through a process of gradual and incremental adjustments to the original tax laws. The development of the tax laws entered a second phase when the income tax was radically transformed into a "mass tax" during World War II. In the post-War era, espe-

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[1] Pub. L. No. 63-16, ch. 16, 38 Stat. 114, 166-81.

cially during the 1970s and 1980s, the level of complexity of the income tax increased dramatically.[2] As reflected by the sheer number of provisions of the federal income tax, there was a virtual explosion in the complexity of the tax code in the post-War period.[3]

In light of this dramatic increase in complexity of the federal income tax, there is a tendency to equate tax reform with tax "simplification."[4] Indeed, tax simplification has emerged as one of the perennial themes in the academic tax literature.[5] Some reform efforts have been directed at specific provisions of the tax code and regulations. Other proposals amount to little more than broad pleas for general simplification and appear to be politically motivated. For instance, House Ways and Means Chairman Rostenkowski and then Finance Committee Chairman Bentsen picked up on the theme of tax simplification and introduced a package of proposals in 1991.[6] These proposed provisions were mostly window dressing and focused on simplification of reporting

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[2] In a recent interview, Professor Martin Ginsburg recounts that even under the Internal Revenue Code of 1954 there were only a few statutory and regulatory "monsters" for tax lawyers to struggle to master. Under the 1986 tax code, the monsters now seem to dominate the playing field. *See* Martin D. Ginsburg, *Interview With Professor Martin D. Ginsburg*, 12 ABA SECTION OF TAXATION NEWSLETTER, Fall 1992, at 6-12.

[3] The Internal Revenue Code and Treasury regulations were first published in 1913 by Commerce Clearing House, Inc. (CCH) in a single volume consisting of little more than 400 pages. This remained the case through World War II. Presently, the tax code and regulations take up a total of eight volumes and over 36,000 pages. There has been a comparable explosion of "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 exploded to 200 pages in the 1970s. This did not even include new sections of the statute, such as medicare. MARTHA DERTHICK, AGENCY UNDER STRESS: THE SOCIAL SECURITY ADMINISTRATION IN AMERICAN GOVERNMENT 201 (1990).

[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 provisions.").

[5] *See, e.g.*, HENRY C. SIMONS, FEDERAL TAX REFORM 28-30 (1950); Paul McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27 (1978); *Federal Income Tax Simplification* (Charles H. Gustafson ed., 1979); U.S. Department of Treasury, Office of Tax Analysis, *Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President*, 25 TAX NOTES 873 (1984); Joint Comm. on Tax'n, 95th Cong., 1st Sess., Issues in Simplification of the Income Tax Laws (Comm. Print 1977); Sidney I. Roberts, *Simplification Symposium*, 34 TAX L. REV. 5 (1978); Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1 (1974); Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); Charles A. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25 (1989).

[6] TAX SIMPLIFICATION ACT OF 1991, S. DOC. NO. 1394, H.R. DOC. NO. 2777, 102d Cong., 1st Sess. (1991).

on tax returns. Even former IRS Commissioner Goldberg promoted tax simplification, but he left unstated precisely what that meant.[7]

These and many other proposals for simplification make for good press, but do not address the fundamental causes behind the rise in tax complexity. Few of the reformers posturing for simplification of the tax laws recognize the inherent difficulties in any attempt to simplify the code. Some of the excess complexity is attributable to efforts by policymakers to accomplish too much through the tax laws. In other instances, the great complexities of the tax laws are attributable to prior reforms enacted in the pursuit of ever greater purity 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."[8] Long's proposition is worth considering, even if it lacks a certain critical perspective as evidenced by Long's own willingness to enact countless special provisions for the sole benefit of his constituent gas and oil industries.

The causes behind the enormous complexity in the tax laws cannot be reduced to any single factor. Thus, open-ended calls for "simplification" to cure the problem of complexity ring almost as hollow as the claim that tax complexity is attributable to the search for "more perfect justice" in the tax code—both claims are overly simplistic. In order to intelligently discuss tax simplification, it is necessary to consider why the tax laws became overly complex in past decades, and to recognize the infirmity of overly complex 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.

To understand the adverse effects caused by overly complex tax laws, one needs first to view the federal income tax from a broad historical perspective to place the development of the tax system as a whole within the context of the peculiar structure of American political institutions. Complexity does not enter the tax code so much out of malevolence as through misguided reform efforts and excessive demands made on tax laws as the vehicle for implementing public policy. After understanding the broader context, it is possible to identify those trends in recent tax policymaking that have contributed to this unfortunate rise

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[7] *See* Lane Davenport, Marianne Evans, and Sean Ford, *Goldberg Still Beating Drum For Simplification; Says IRS Budget is Way Out of Balance*, 45 TAX NOTES 1398 (1989).

[8] TIMOTHY J. CONLAN ET AL., TAXING CHOICES 141 (1990) (quoting *Senate Finance Committee Hearings on Tax Reform Proposal, Volume 3*, 99th Cong., 2d Sess., 53 (1986) (statement of Senator Russell Long, Former Chairman, Senate Finance Committee)).

in tax complexity. The dilemma that we may very well confront is that the more we attempt to do through the tax code—whether to achieve a "more perfect justice" or implement social economic policies—the more we end up making the tax laws even more complex. In doing so, we undermine the capacity of the citizen/taxpayer to comprehend the legal obligations imposed under the regime of the federal income tax.

I. COMPLEXITY IN THE FEDERAL INCOME TAX LAWS

A. *The First Regime of the Federal Income Tax*

1. The Original Tax System

Tax complexity is not a new phenomenon, although it has reached new heights in recent decades. Since 1913, excessive complexity has been a constant complaint of taxpayers as well as a favorite theme of reformers.[9] But to taxpayers and counsel who have grown accustomed to the statutory excesses and regulatory quagmires that seemed to become the norm in the 1980s, the first income tax laws would appear relatively straight-forward and uncomplicated.

For instance, the original Form 1040 ("Return of Annual Net Income of Individuals"), put in service by the Bureau of Internal Revenue in 1913, was only three pages long, including all its various schedules. It contained only a single page of instructions.[10] The return required taxpayers to compute and report just two separate items, "gross income" and total "general deductions," and provided relatively straightforward schedules for computing each. The tax was imposed on net income above a $3,000 exemption that was "received or accrued" during the calendar year, thus employing a hybrid method of tax accounting that borrowed concepts from the cash and accrual methods of

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[9] Senator Elihu Root of New York in 1913 wrote to a friend who had complained about the complexity of the Revenue Act of 1913: "I guess you will have to go to jail. If that is the result of not understanding the Income Tax Law I shall meet you there. . . . [F]or no one understands the Income Tax Law except persons who have not sufficient intelligence to understand the questions that arise under it." Quoted in HAROLD DUBROFF, THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS 12 (1979).

[10] The 1993 Form 1040 is just two pages long, but completing a complicated return may require the use of dozens of schedules and worksheets. Form 1040 alone is now accompanied by almost fifty pages of instructions and worksheets.

tax accounting so familiar in the modern code.[11] Essentially, the 1913 income tax resurrected the short-lived Civil War income tax as well as the tax return used fifty years earlier.[12]

Of course, many sophisticated taxpayers struggled with the new relatively "simple" income tax form.[13] Notwithstanding that the 1913 version of the federal income tax was rather basic and pristine by today's standards, it already was perceived by contemporaries as far too complicated to be understood by the average taxpayer.[14] The impact and shock felt by those confronting the new federal income tax law for the first time in 1913 may have been even worse than the bewilderment felt today by those who make their first acquaintance with the present incarnation of the code. The sheer novelty of the idea of measuring an individual's "income," as the new tax required, was part of the reason that the first income tax laws would have struck individuals as so complex and shocking.[15] Corporations were already familiar with the notion of computing income over a defined accounting period, both for financial and tax purposes. A federal business privilege tax, similar in essence to an income tax, had been enacted and sanctioned four years prior to the ratification of the Sixteenth Amendment.[16] But individuals were not yet accustomed to measuring their human endeavors in terms

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[11] *See* I.R.C. § 446(c) (cash and accrual methods as "permissible methods" for computing taxable income). [All citations herein are to the Internal Revenue Code of 1986, as amended, unless otherwise specified.]

[12] The tax return used during the Civil War employed a similar framework. However, the return used in 1865 listed separately each source of income (specifically, all "profits from any trade, business, or vocation," rental income from land or buildings, "profits realized" from the sale of real property, as well as interest and dividends) and allowed for "proper" deductions related to that source of income. Allowing for deductions for losses sustained on the sale of real estate, interest paid, rent actually paid for the taxpayer's "homestead," and an annual exemption for \$600 of salary for military personnel, the tax was imposed upon net income above a \$600 personal exemption. For an account of the Civil War income tax, see ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 2-8 (1940); RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES 7-29 (1954).

[13] Indicative of the fact that even the rudimentary tax return used for the Civil War income tax was difficult for taxpayers to comprehend, Abraham Lincoln overpaid his taxes for 1864 by \$1,250, a sizable amount by contemporary standards of wealth. The incident is recounted in DAVID BURNHAM, A LAW UNTO ITSELF: THE IRS AND THE ABUSE OF POWER 13 (1989).

[14] *See supra* note 9.

[15] Except for the brief experience with the Civil War income tax, a half century prior to the 1913 income tax, citizens had only known "indirect" forms of taxation. While transactions and sales were subject to excise taxes and custom duties, the concept of treating an individual as a taxable economic unit was relatively new, even in 1913.

[16] The corporate business privilege tax was included in the Payne-Aldrich Tariff Act of 1909, which was imposed "with respect to the carrying on or doing business" of corporations. In Flint v. Stone Tracy Co., 220 U.S. 107 (1911), the U.S. Supreme Court held the tax to be a business

of "net income." Nor were they accustomed to being treated as discrete economic units—"accounting" for their lives as so many living balance sheets. No matter how benign the federal income tax may appear by today's standards, it represented a milestone in the development of the relationship between the citizen and the state, transforming the American citizen into a new category of being—the Taxpayer.

Oddly enough, the simplicity of the first "bare-bones" tax laws may have actually contributed to the initial confusion because they provided taxpayers with insufficient guidance as to what was being measured and how to measure it. Successive decades of refinement of the statutes by lawmakers, as well as the issuance of interpretive regulations by the Treasury Department under the authority granted by the Revenue Act of 1928,[17] somewhat clarified the meaning of the basic concepts of the federal income tax. These interpretations brought greater certainty and predictability of outcome to subsequent generations of taxpayers, attorneys, and tax experts.

2. Role of the Federal Courts

During the first decades of the federal income tax, the federal courts and the Board of Tax Appeals contributed much flesh and blood to the statutes.[18] Indeed, the basic nature of the statutes and the broad, expansive language used by Congress in drafting the initial revenue laws made extensive litigation inevitable. Accordingly, the federal courts were drawn into a process of articulating the meaning of the most basic and fundamental concepts of the income tax.

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privilege tax, and not an income tax which would have been prohibited under Article I, Section 9 of the U.S. Constitution as a "direct tax."

[17] Pub. L. No. 78-562, ch. 852, 45 Stat. 790, 791 (1928).

[18] The Board of Tax Appeals was established under the Revenue Act of 1924, ch. 234, § 900, 43 Stat. 336-38. The Board was technically an "independent agency in the executive branch," rather than a judicial body. In fact, the Board (which was renamed the Tax Court of the United States in 1942) functioned much as a federal trial court. In 1969, in recognition of this, Congress renamed the body the "United States Tax Court" and reclassified it as a so-called "Article I" federal court (*i.e.*, a judicial entity created under the authority granted to Congress in Article I of the U.S. Constitution). 26 U.S.C.A. § 7441 (Law. Co-op. 1993). Nevertheless, the hybrid nature of the Tax Court still raises problems. *See, e.g.*, Freytag v. Comm'r, 111 S. Ct. 2631 (1991) (concerning the power and authority of the "special trial judges" of the Tax Court); *see also Note: Special Trial Judges, The Tax Court and the Appointments Clause: Freytag v. Comm'r*, 45 TAX LAWYER 497 (Winter 1992). For a history of the U.S. Tax Court, see HAROLD DUBROFF, THE UNITED STATES TAX COURT: AN HISTORICAL ANALYSIS (1979).

a. *Defining Income*

The federal courts were called upon to define the most fundamental concept of the tax laws—what is "income" for purposes of the new tax. The statutory definition of "income" provided in the Revenue Act of 1913 merely mirrored the language of the newly ratified Sixteenth Amendment, which sanctioned the imposition of a "direct" tax on "incomes, from whatever source derived. . . ."[19] Since 1913, the statutory language has remained virtually identical. The present definition is found in Section 61(a) of the Internal Revenue Code of 1986 and simply states, somewhat tautologically, that: "gross income means all income from whatever source derived. . . ."[20] The broad net cast by the statute provides considerable room for debate and disagreement between reasonable persons over what constitutes "income"—especially, where the source is a gift, bequest, life insurance or some other source of income exempt by statute or judicial doctrine.

Given the minimal and somewhat cryptic statutory definition of income, it was perhaps inevitable that the United States Supreme Court would be called upon to provide further clarification of the concept of income very early in the history of the new tax. In *Eisner v. Macomber*, the Supreme Court struggled with the concept, declaring in 1920 that "income may be defined as the gain derived from labor, from capital, or from both combined."[21] In this statement, the Court (probably unintentionally) considerably narrowed the constitutional and statutory definition of income as it strongly implied that absent the contribution of labor or capital, a gain would not be included in income. Such an interpretation would leave vast categories of "gain" out of the statutory scheme, and hence, out of the reach of the federal tax collector. In construing the statute so narrowly, the Court introduced additional confusion into an already uncertain area[22] and offered litigation-minded taxpayers a basis for disregarding the broad all-encompassing statutory definition of income when preparing their tax returns.

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[19] U.S. CONST. amend. XVI.

[20] I.R.C. § 61(a). The 1939 Internal Revenue Code relied upon a somewhat more wordy definition of "gross income" in section 61(a), while the 1954 tax code returned to a definition closer to that first used in 1913.

[21] Eisner v. Macomber, 252 U.S. 189, 207 (1920).

[22] *See* MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 7 (4th ed. 1985) ("[C]ould it be asserted that 'labor' or 'capital' somehow inheres in every human activity? The Macomber definition apparently possessed metaphysical properties which made it difficult to apply in an absolute fashion. . . .").

From the practitioner's perspective, this confusion was a positive development. It supported aggressive "reporting positions" that would exclude from taxable income accessions to a client's wealth not derived from either labor or capital (such as gifts) and invites litigation over such claimed exclusions.[23]

It was not until 1955 in the case of *Commissioner v. Glenshaw Glass Co.* that the Supreme Court finally settled the issue by embracing the broad language of the Sixteenth Amendment, including virtually everything in income. The Court defined income as all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[24] The judicial adoption of this broad definition also resolved the issue reasonably well for purposes of creating an administrable definition of income for the tax code. The statutory scheme is that every "accession" to wealth is presumptively included in income unless otherwise specifically excluded by statute, and in some limited circumstances, by judicial doctrine.[25] The Bureau of Internal Revenue and later, the Internal Revenue Service, had always adopted this structure

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[23] *See, e.g.*, Bogardus v. Comm'r, 302 U.S. 34 (1937); Robertson v. United States, 343 U.S. 711 (1952); Commissioner v. Duberstein, 363 U.S. 278 (1960) (donative intent required for non-taxable gift).

[24] Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

[25] Since the broad definition of income was adopted, there is little room left for judicial exceptions to the general rule that all "accessions to wealth" are included in income. However, during the years of the Depression in the 1930's, the courts commonly enunciated exceptions to the broad definition of inclusion in income. For instance, after outlining the rule for including income realized on the discharge of indebtedness—a common occurrence during the Depression when the value of real property declined severely, leaving many mortgage lenders inadequately secured and willing to accept partial pay-offs of loans—the courts carved out a number of rather dubious judicial exceptions that are only recently being withdrawn by the courts (although the Treasury never acquiesced in most of these decisions from the first). *See* Kirby Lumber Co. v. United States, 284 U.S. 1 (1931) (in the majority opinion, Justice Holmes holds that income was realized by a corporation upon acquisition of its own debt instrument for less than face value); *but see* Bowers v. Kerbaugh-Empire, 271 U.S. 170 (1926) (where "overall transaction" was a loss, income not recognized on discharge of debt for less than face value); Fulton Gold Corp. v. Comm'r, 31 B.T.A. 519 (1934) (reduction in non-recourse debt is treated as a basis reduction rather than recognized as income). *Kerbaugh-Empire* and *Fulton Gold* have been severely criticized by courts and the IRS for years. *See, e.g.*, Vukasocvich, Inc. v. Comm'r, 790 F.2d 1409, 1414 (9th Cir. 1986). Indeed, the whole debt-discharge area is still not supported on a firm theoretical foundation, as evidenced by the recent bizarre case of Zarin v. Comm'r, 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3d Cir. 1990) (compulsive gambler lost $3.5 million in casino gambling on credit and in settlement with casino, he paid $500,000 of the debt—IRS asserted that taxpayer recognized $3 million of income from cancellation of indebtedness). For one of the better discussions of *Zarin*, see Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 54 TAX L. REV. 215 (1990).

in litigation as the basic framework of the federal income tax even prior to the Court's adoption of a similar view of "income" in 1955.

In these and other early decisions, the federal courts crafted a practical and administrable concept of income for the new income tax; and even as the tax code evolved and provided greater details of other statutory definitions, the definition of "income" remained very much a question determined by reference to these early judicial decisions. However, there still remains a sizeable grey area as to what amounts to income subject to the grasp of the federal income tax, even after decades of judicial construction.[26]

The courts also performed the essential task of drawing the boundaries of administrative power by reviewing the government's own interpretations of the tax statutes. While the courts paid all the usual deference to the expertise of the tax experts in the administrative agencies with respect to their interpretation of the tax laws, there was little hesitancy to find in favor of taxpayers against the tax authorities. Through extensive litigation over the basic issues arising under the federal income tax, the courts enunciated the broad doctrine necessary to fill in the considerable gaps in the tax laws and restrained the tendency of the government to construe the tax laws entirely in its own favor. In this respect, the federal courts played an instrumental role in the development of the federal income tax.

3. Development of the Tax System During the First Regime

During the first quarter of a century under the new federal income tax—the "first regime"—the statutory framework of the tax was clarified by Congress, the administrative capabilities of the Treasury were expanded and refined, and the courts acquired experience and skill in interpreting the tax laws. Likewise, as the increasingly professionalized and specialized bar became more familiar with the meaning of the new

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[26] "Construction" has been defined as the "drawing of conclusions respecting subjects that lie beyond the direct expression of the text, from elements known from and given in the text — conclusions which are in the spirit though not the letter of the text." FRANCIS LIEBER, *Legal and Political Hermeneutics* 44 (F.H. Thomas 1880), *quoted in* William F. Harris II, *Bonding Word and Polity: The Logic of American Constitutionalism*, 76 AM. POL. SCI. REV. 34, 40 (1982); *see also* Frank H. Easterbrook, *Legal Interpretation and the Power of the Judiciary*, 7 HARV. J.L. & PUB. POL'Y 87 (1984); Sheldon D. Pollack, *Constitutional Interpretation as Political Choice*, 48 UNIV. PITT. L. REV. 989 (1987).

tax laws through experience representing clients, a new legal specialist was born—the tax lawyer.[27]

Thus, the first regime of the federal income tax was marked by the gradual institutionalization of the tax system, the professionalization of roles played by the participants, and the specialization of functions within the administration of the tax system. This specialization included locating the power to interpret the tax laws through administrative regulations and the power to actually collect tax revenues in separate offices and agencies. During this period, the basic structure of the federal income tax was laid out and the participants in the administration of the tax laws eventually came to understand the rules of the tax system. In addition, Congress made continual refinements to the tax statutes based upon experience in administering the tax laws. These statutory refinements, along with judicial doctrine as it had evolved since 1913, were codified in the Internal Revenue Code of 1939.[28] The 1939 tax code included most of the basic features of the present income tax regime. The "expansive" language of the first revenue statutes was given detail through decades of statutory amendments, administrative pronouncements, and judicial review. Yet, even after paying federal income tax for more than a quarter of a century, the new tax code of 1939 struck contemporaries as forbidding and enigmatic.[29]

During the first regime, the existing administrative capacities of the American government proved to be sufficiently developed to collect the revenue from the income tax. Because only 1% of the population was subject to the individual income tax in 1913, and only 5% subject to the tax in 1939, there was no great pressure for an expansion of

[27] From 1905 to 1916, the American Bar Association maintained a Standing Committee on Taxation which participated in the enactment of the Revenue Act of 1913. The ABA's Special Committee on Internal Revenue was instrumental in the creation of the Board of Tax Appeals. In 1939, the ABA approved the organization of the Section of Taxation, which today plays a prominent role in advising the Treasury and IRS on concerns of the tax bar. For a discussion of the role of the Tax Section, see Harry K. Mansfield, *A Brief Unofficial History of the Tax Section — 1939-1989*, 44 TAX LAWYER 4 (1990).

[28] Pub. L. No. 76-1.

[29] No less a distinguished figure than Judge Learned Hand expressed these sentiments with respect to the complexity of the 1939 tax code:

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception — couched in abstract terms that offer no handle to seize hold of — leave my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.

JAMES S. EUSTICE, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7, 7 (1989).

administrative powers into the area of taxation.[30] Thus, the traditional nineteenth century system of administration—minimal state institutions, organized by political parties, subject to judicial review[31]—predominated throughout the first regime of the federal income tax. However, the gradual development of the federal income tax system, including the code itself and the collection system, was radically and abruptly altered by the revenue crisis occasioned by World War I.

During the fiscal crisis of the war, policymakers learned an important lesson about the individual income tax—the amount of revenue collected can be increased fairly easily through the tax system with only relatively minor tinkering and adjustments to tax rates and exemption levels. Accordingly, the wartime crisis for additional revenue led to higher marginal tax rates, thereby transforming the nominal structure of the federal income tax into a highly progressive tax.[32]

Political scientist John Witte has described the impact of World War I on the development of the federal income tax as follows:

> The First World War had an important impact on the income tax, rapidly transforming it from a highly contested but insignificant source of revenue into a major tax. Rate and provision adjustments made over several years turned what was almost a proportional tax into one with a highly progressive nominal rate structure.[33]

Despite the importance of World War I on restructuring the federal income tax, the impact of the War proved to be transitory. Even during the height of World War I, only a relatively small proportion of the citizenry was ever subject to the federal individual income tax. In addition, as revenue requirements of the federal government returned to more traditional patterns after the War, tax rates also were quickly

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[30] Figures cited in Timothy J. Conlan et al., *Taxing Choices: The Politics of Tax Reform* 17 (1990).

[31] *See* STEPHEN SKOWRONEK, BUILDING A NEW AMERICAN STATE: THE EXPANSION of NATIONAL ADMINISTRATIVE CAPACITIES, 1877-1920, 29 (1982) ("Together, courts and parties formed the bulwark of the early American state.").

[32] The top tax rate imposed during World War I was 77% on income over one million dollars. ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX 20 (1985).

[33] JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 110 (1985).

reduced to pre-War levels.[34] Furthermore, following the War, the federal government actually ran surpluses, leading Treasury Secretary Andrew W. Mellon on a crusade for the repeal of the wartime excess profits tax.[35]

B. *The Second Regime: The Transformation of the Tax System*

The critical need for revenue brought on by World War II led to dramatic increases in tax rates as well as the transformation of the federal income tax from a "class tax" into a "mass tax" affecting most of the citizenry.[36] The expansion of the American administrative state during the New Deal had already established a conceptual and ideological acceptance of public administration, paving the way for the subsequent expansion of the tax administrative state during World War II.[37]

During the War years, tax rates and the volume of revenue collected increased dramatically.[38] Similarly, the number of tax returns filed by individuals increased nearly eightfold from 1940 to 1945.[39] From the initial 1% of the population that was subject to the individual income tax in 1913, the figure had risen to only a modest 5% by 1939.[40] However, this changed dramatically over the course of World War II. Furthermore, the structural changes to the tax code occasioned by the war were not withdrawn following World War II as they had been after World War I. The higher tax rates and the expanded scope of the tax did not return to pre-War levels, and they continued to increase, although more slowly, throughout the post-War years. By 1950,

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[34] *Id.* at 96; *see also* BLAKEY and BLAKEY, *supra* note 12, at 189-334 (account of Mellon plan for tax reduction during 1920s, including legislation that reduced wartime surtax rates, estate taxes, and corporation taxes in 1924, 1926 and 1928, respectively).

[35] Mellon, Treasury Secretary under four presidents, played the leading role in the return to tax "normalcy." Under Mellon's long reign at Treasury, wartime debt was significantly reduced and the budget actually yielded surpluses for eleven straight years, even as the wartime excess profits tax was abandoned. *See* Paul, *supra* note 12, at 122-42. While tax rates decreased, the relative contribution of the income tax to total federal revenue increased during the 1920s. RICHARD B. GOODE, THE INDIVIDUAL INCOME TAX 2-3 (1976).

[36] *See* C. EUGENE STEUERLE, THE TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA 13 (1992); WITTE, *supra* note 33, at 110-30. The most comprehensive discussion of the expansion of the income tax during World War II is found in PAUL, *supra* note 12, at 249-392.

[37] *See* DONALD R. BRAND, CORPORATISM AND THE RULE OF LAW: A STUDY OF THE NATIONAL RECOVERY ADMINISTRATION (1988); *see also*, SKOWRONEK, *supra* note 31, at 288-90.

[38] *See* WITTE, *supra* note 33, at 110-30.

[39] CONLAN, *supra* note 8, at 18.

[40] *See* GOODE, *supra* note 35, at 3.

as much as 59% of the population was subject to the individual income tax, and that figure increased to 81% by 1970.[41] Revenue from the federal income tax rose to 45% of all federal tax receipts by 1950, and by 1985, the figure had risen to 73%.[42]

Thus, the great impact of World War II on fiscal policy was that the federal income tax emerged as the most significant source of revenue for the federal government as both tax rates increased and more of the population became subject to the tax. The federal income tax also became one of the most wide-ranging and all-encompassing of American public policies, affecting many aspects of social and economic life of the citizenry through the public policies built into the tax code and imposing what may very well be the most burdensome obligation of citizenship.

Perhaps the single most important change in the tax laws implemented during World War II that made possible the creation and extraordinary growth of the post-War tax administrative bureaucracy was the introduction of so-called "withholding at the source."[43] Withholding was contemplated and favored by those who enacted the first income tax in 1913, in particular Cordell Hull (Dem., Tenn.), Chairman of the House Ways and Means Committee. Supporters generally viewed with favor the British system of "collection-at-the-source," which imposed a flat rate on prescribed payments and was indifferent to the income or financial status of the recipient, and thus, was highly administrable.[44]

Withholding at the source was not actually put into effect until 1943 pursuant to the Current Tax Payment Act enacted during the wartime crisis for revenue. Until this legislation, the individual income tax was paid solely through quarterly payments of estimated tax for the current year.[45] The Roosevelt administration had been recommending

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[41] *Id.* at 19.

[42] *Id.*

[43] *See, e.g.*, BURNHAM, *supra* note 13, at 15 ("Although the withholding statute traditionally receives only passing attention from most tax scholars, its importance in increasing the basic power of the IRS cannot be overstated."). For a discussion of the politics behind the enactment of the first withholding requirements, see PAUL, *supra* note 12, at 333-34.

[44] *See* BLAKEY AND BLAKEY, supra note 12, at 75, 511-20. Proponents of withholding at the source also looked to the English experience with envy as it raised significant revenue through this device.

[45] This is still the method of payment of tax with respect to self-earned income. *See* I.R.C. §§ 6315, 6654 (Law. Co-op. 1993). Technically, there is no requirement to pay such estimated taxes. However, there are penalties for the failure to make adequate quarterly payments of one's annual income tax liability. Absent these provisions, individuals would not need to make any in-

withholding requirements in order to speed up the collection of the badly needed revenue to which the national government now laid claim under the newly expanded federal income tax. The new legislation created a new obligation for payers of compensation, interest and dividends to withhold a prescribed amount of income tax from the payment itself.[46] In addition to the introduction of withholding at the source, "information reporting" requirements also were created and imposed upon the same categories of payers. Later, legislation was enacted to require the payers of compensation, interest, and dividends to report such payments to the IRS on an annual basis.[47] Over subsequent decades, withholding and information reporting requirements were constantly expanded through the incremental tax policymaking process.

Information reporting provides the IRS with independent notice and verification of much of the gross income of most of U.S. resident taxpayers. With information reporting applicable to the payment of wages to employees, remuneration paid to independent contractors, interest and dividend payments, and even the gross proceeds realized from the sale of stock and securities, the IRS now has available to it significant information regarding the tax status of a significant percentage of taxpayers. Of course, such information is useless without the administrative capacity to digest the vast, and potentially overwhelming, volume of information that the IRS receives from payers with respect to taxpayers. Computers now offer the IRS the capability to correlate and match all the vast and otherwise incomprehensible information gathered from these payers.[48] On the whole, withholding and information reporting greatly changed the posture of the IRS and the income tax from a "self-assessed" tax paid on an annual basis by the taxpayer himself, to one in which payments and a good deal of the

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come tax payments until April 15th of the following year — the due date for their income tax return.

[46] The withholding requirements, expanded greatly since introduced in 1943, are now found in the I.R.C. at §§ 3401-06.

[47] These obligations are imposed upon payers under I.R.C. §§ 6041-50N.

[48] The IRS computer system is hopelessly out-of-date. Under the Bush administration the IRS began an $8 billion modernization program. Scott R. Schmedel, *Tax Report: The IRS Is Reshaping*, WALL ST. J., July 7, 1993, at A1. Such a measure is believed to be cost-effective. Memories of a much-publicized breakdown in the IRS computer collection system in 1985 still haunt the attempt to rely upon computers to keep track of so much of the economic activity subject to the income tax.

relevant information is in the hands of the taxing authorities even before the taxpayer starts to prepare an annual tax return.[49]

With the introduction of income tax withholding during the war years, the Internal Revenue Service was able to enhance the enforcement of compliance with the tax laws.[50] This trend continued over the next decades as computers have allowed even greater and more extensive withholding requirements to be imposed upon private, third-party payers such as employers, banks, and securities and brokerage clearing houses. With such new and enhanced tools for ensuring withholding at the source, the Internal Revenue Service has emerged as one of the most productive of administrative agencies. Notwithstanding the popular perception that the IRS is somehow inefficient in its operations, its ability to administer a mass tax with over one hundred million tax returns filed annually and collect nearly one trillion dollars of revenue each year, is truly a miracle of modern bureaucracy.[51]

If World War II helped to establish the federal income tax as one of the most important fiscal tools of the American polity, tax policymaking during the immediate post-War era followed much the same patterns that had prevailed during the pre-War, Depression era politics.[52] Furthermore, the post-War era was a period of relative calm in the political world with respect to the federal income tax. During the entire decade of the 1950s, there was little notable legislation other than the enactment of the Internal Revenue Code of 1954—essentially a recodification, rather than a departure from current law.[53] For the remainder of the decade, the federal tax laws remained quite stable and constant with little significant legislation enacted.[54]

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[49] Even with the powers derived from withholding, information reporting, and computers, in 1993 the IRS still faced a backlog of some $71 billion of unpaid taxes. Tom Herman, *Tax Report*, WALL ST. J., Jan. 20, 1993, at A1.

[50] For an interesting, if uncritical portrait of the Internal Revenue Service, see John C. Chommie, *The Internal Revenue Service* (1970).

[51] The IRS predicted that it would receive nearly 113 million individual tax returns for tax year 1992 by the end of September 1993. This represents a slight decrease over the prior year. Daily Tax Report (BNA), September 28, 1993, G-3. Nearly one trillion dollars was collected for tax year 1988. BURNHAM, *supra* note 13, at 22. The IRS' own budget is $7.4 billion under the fiscal year 1994 budget put forth by the Clinton administration. DAILY TAX REPORT, June 10, 1994, G-4.

[52] For a description of post-War patterns of tax policymaking, see WITTE *supra* note 33 at 131-54.

[53] For a discussion of the 1954 revenue bill, see WITTE, *supra* note 33, at 148-50.

[54] One important piece of tax legislation enacted during the 1950s was the addition of Subchapter S to the Internal Revenue Code in the Technical Amendments Act of 1958, H.R. DOC. NO. 8381, 85th Cong., 2d Sess.

The new mass income tax provided the Treasury Department with significantly more revenue and became the most important single source of federal revenue. However, to accommodate this expansion of the tax and the rise in tax rates, the tax administrative state had to be augmented to collect the revenue available to the government under the expanded federal income tax.[55] While the traditional nineteenth century administrative state had been adequate in collecting the tariff, and was easily adapted to administer the early income tax laws, the wartime enlargement of the income tax required a major expansion and reconstitution of the federal tax bureaucracy to administer the revenue laws as a mass tax applicable to millions of new taxpayers.[56]

A good deal of the complexity that invaded the tax code in the post-War era can be traced to this transformation of the income tax into a mass tax and to the related expansion of the tax administrative state. However, the causes behind the explosion in tax complexity in the post-War era go beyond these factors alone. To understand the explosion in complexity that has been witnessed since the 1970s, it is necessary to consider other factors that have contributed to the unprecedented rise in tax complexity.

II. SOURCES OF TAX COMPLEXITY

A. *Economic Complexity*

The dramatic increase in the level of the complexity of the federal income tax laws during recent decades has not gone unnoticed.[57] Indeed, it has been a favorite theme of tax academics, politicians, and the

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[55] *See* CHOMMIE, *supra* note 50, at 24 ("The broadening of the income tax base during the early years of World War II to embrace most of the nation's wage earners, necessitated the utilization of a number of new and innovative collection techniques.").

[56] The total revenue collected by all levels of government in the United States was $50 billion in 1944 during the height of World War II; $100 billion in 1956; $500 billion in 1977; and $1 trillion in 1984. RONALD F. KING, MONEY, TIME, AND POLITICS: INVESTMENT TAX SUBSIDIARIES AND AMERICAN DEMOCRACY 16 (1993).

[57] Writing in 1950, Henry Simons elegantly lamented the increased complexity of the tax laws, but could offer only a vague explanation for it and little hope for relief: "Simplicity in modern taxation is a problem of basic architectural design. Present legislation is insufferably complicated and nearly unintelligible. If it is not simplified, half of the population may have to become tax lawyers and tax accountants." SIMMONS, *supra* note 5, at 28. *See also* HALL and RABUSHKA, *supra* note 32, at 5 ("The current U.S. income tax system is a nightmare of complexity.").

tax bar.[58] However, the many explanations offered for the increased complexity of the tax laws are less than convincing or satisfactory. The problem of tax complexity goes to the heart of what is wrong with tax policymaking in the post-War period, and thus, requires more than simplistic explanations or eloquent lamentations.

The reason most often cited for the increased complexity in tax laws is the purported increase in the complexity of the "world" in general, and in the economy in particular. According to this common argument, the tax laws were necessarily expanded during the post-War period in response to, and to cope with, the increasingly sophisticated and complicated world of business, corporate finance, and economic relations. Purportedly, as business transactions became more complex, Congress was required to modify the income tax laws just to keep up with the new practices of business.[59]

1. International Taxation

There is a good deal of truth in the argument that the increasing complexity of business transactions leads to increasing complexity in the tax laws. For instance after the 1950s, American businesses progressively expanded their activities in foreign markets and foreign corporations increasingly began to do much more business in the United States. This change in the international economic environment demanded adaptation of income tax laws to govern the taxation of multinational business transactions and corporations conducting business in several jurisdictions. Accordingly, the provisions of the tax code with respect to "international taxation"[60] greatly expanded beginning in the

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[58] For a discussion of the forces pushing toward greater complexity, *see generally*, Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969); Sidney I. Roberts et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972); James S. Eustice, *Tax Complexity and the Tax Practitioner*, 45 TAX L. REV. 7 (1989).

[59] *See, e.g.*, WITTE, *supra* note 31, at 149 ("[T]he U.S. economy had become much more complex by the 1950s, and the rudimentary laws of the early income tax were no longer sufficient."). In a comparable example, Wildavsky attributes the complexity of the budgeting process to similar factors. AARON B. WILDAVSKY, THE POLITICS OF THE BUDGETARY PROCESS 8 (1964) ("Budgeting is complex, largely because of the complexity of modern life.").

[60] Within the context of the U.S. income tax laws, "international taxation" has a somewhat misleading usage, referring to the taxation by the U.S. of domestic corporations and U.S. persons with foreign branches and/or income sources outside the United States, as well as taxation of foreign corporations and individuals with U.S. source income gained by conducting business and investment activities in the United States. For an excellent and comprehensive three-volume trea-

1960s. Some of the most complicated provisions to deal with international tax issues in the code were introduced during the 1980s. For instance, foreign corporations conducting business in the United States must now confront extremely complicated statutes and regulations which require them to determine their "U.S. source" income,[61] their "effectively connected" U.S. income,[62] and their U.S. interest deductions.[63] They also must negotiate the "branch profits tax"[64] and complicated economic analysis required with respect to so-called "intercompany transfer-pricing."[65] There is little doubt that in international taxation, tax complexity caught up to international business practices with a vengeance of its own.

2. Tax Law and Business Forms

Whatever the initial appeal of the argument that the tax laws increased in complexity in response to the increasing complexity of the world, the economy, or even life itself, it is not entirely convincing. For instance, the argument assumes that the use of new entities to conduct

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tise covering all aspects of international taxation, see JOSEPH ISENBERGH, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN TAXPAYERS AND FOREIGN INCOME (1990).

[61] *See* I.R.C. § 861-62 (1986) (defining income from "U.S. sources" and income from sources outside the U.S.). Specific provisions of the tax code governing the taxation of foreign corporations and nonresident aliens are found in Subpart II of Subchapter N of the Internal Revenue Code.

[62] For the definition of "effectively connected" income, see I.R.C. § 864(c) (1986).

[63] For example, the determination of the portion of a foreign corporation's U.S. debt allowable as a deduction under the U.S. income tax laws requires an allocation of world-wide debt based upon the location of the foreign corporation's assets. *See* Treas. Reg. § 1.882-5 (interest allocation rule) promulgated under the authority of I.R.C. § 882(c)(1)(A) (1986). *See also* I.R.C. § 863 (1986).

[64] *See generally*, I.R.C. § 884 (1986).

[65] Intercompany transfer-pricing is governed under I.R.C. § 482 (1986). Spurred on by media accounts of foreign corporations grossly underpaying their U.S. income taxes, the Treasury Department began to pay serious attention to transfer-pricing in the 1960s. A STUDY OF INTERCOMPANY PRICING, Notice 88-123, 1988-2 C.B. 458, at 6-10. Treasury issued a so-called "White Paper" in 1988 on the question of transfer-pricing. A STUDY OF INTERCOMPANY PRICING, Notice 88-123, 1988-2 C.B. 458. The White Paper was a radical departure from the usual attempt by the Treasury to describe and address every conceivable transaction and set of facts and circumstances in its regulations. This paper was devoted exclusively to transfer-pricing. However, after publication of the White Paper, the Treasury Department began the inevitable barrage of regulations, and many taxpayers objected to them on various grounds. The Treasury retreated somewhat and issued "simplified" regulations in January of 1993. Nevertheless, even these regulations impose highly technical standards that must be negotiated to avoid having the IRS recompute a corporation's income. Treas. Reg. §§ 1.482-1 through 1.482-2 and Temporary Reg. §§ 1.482-1T though 1.482-7T.

business led to the expansion of the tax laws to regulate such developments in business practice.[66] This is contrary to the thesis that American law evolved and developed to accommodate the needs and interests of the dominant economic interests of civil society—*i.e.*, modern capitalism.[67] The former implies that autonomous political elites are capable of responding to attempts to avoid the incidence of the income tax by crafting new statutes and regulations to cope with such developments in business practice, while the latter argument presumes that law develops in conformity with the needs of the business community.

It is relatively easy to find examples supporting both sides of the argument. For instance, in 1958 Congress passed legislation that provided for the creation of an entirely new tax entity, the so-called "S corporation," for the express purpose of providing business with a new "pass-through" entity as an alternative to the traditional business corporation.[68] The S corporation is strictly a creature of the federal tax code, and its creation illustrates how the tax laws can develop to accommodate private economic interests.

However, just as often it is the tax laws that produce changes in business practices, as well as in state corporate law. The impact of the tax law on business practice and state law is illustrated by the creation of another entirely new legal entity for conducting business—the limited liability company.[69] In 1977, Wyoming became the first state to enact a statute authorizing the organization of limited liability companies, and Florida followed suit in 1982. However, as late as 1988, there were only a handful of limited liability companies actually organized

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[66] *See, e.g.*, WITTE, *supra* note 33, at 149 ("To match the complexity, the code needed to distinguish between corporations, corporations with income earned abroad, partnerships, holding companies, and a wide variety of tax-exempt and partially tax-exempt organizations. Complex organizations lead to complex sources and flows of income and costs, which in turn lead to demands for different treatment.").

[67] *See, e.g.*, MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW: 1780-1860 (1977); and THE TRANSFORMATION OF AMERICAN LAW: 1870-1960 (1992) (evolution of American law as reflecting dictates of private capital).

[68] Subchapter S (contained in §§ 1361-79 of the 1986 Internal Revenue Code) was first added to the tax code by the Technical Amendments Act of 1958, H.R. DOC. NO. 8381, 85th Cong., 2d Sess. The provisions were not in the original House bill, but rather were added by the Senate Finance Committee. *See* S. REP. NO. 1983, 85th Cong., 2d Sess., 1958 C.B. 1009. The legislative intentions behind the creation of this new taxable entity have never been very clear to the courts, thus making it difficult to construe the many restrictions and rules governing Subchapter S corporations. However, there were clear statements as to the need to accommodate the interest of business in some sort of corporate pass-through entity.

[69] For a discussion of the benefits and problems of using a limited liability company, see Sheldon D. Pollack, *Use of a Limited Liability Company for Conducting Business in Pennsylvania*, LXIV PA. BAR ASS'N. Q. 142 (July 1993).

under those laws. Then in 1988, the IRS issued a favorable public ruling regarding the tax treatment of a Wyoming limited liability company. Stimulated by the Service's classification of the Wyoming limited liability company as a partnership for federal income tax purposes, this new business entity became "hot" and nearly all other states rushed to enact their own versions of the statute.[70] As a result, the landscape for business and tax planning includes yet one more entity, as well as all the new interpretive rules and regulations now being considered by Treasury tax experts to distinguish the limited liability company from other pass-through entities—S corporations and partnerships.[71] Here, the evolution of state corporate law accommodated the dictates of economic interests and developments in federal tax law.

However, it can hardly be said, even in this strong case, that the federal tax laws developed to serve or even accommodate private economic interests. Businesses and individual investors already had turned away from the traditional forms of business corporations. They began to utilize alternative business entities such as partnerships and common law creations, like the Massachusetts business trust, precisely because of the more favorable tax results that could be achieved through use of such entities. As tax lawyers came to recognize the advantages to be gained by "restructuring" the traditional forms of business transactions through the use of partnerships, business practices changed to accommodate the federal income tax code. This suggests that tax laws play an independent role in shaping the development of business practices, rather than merely reflecting and serving the needs of private capital. The expansion of the federal tax scheme within civil society had an impact upon how the economy developed and contributed in its own way to the increase in complexity of business practices. Thus, the rise in complexity of the tax laws cannot be attributed solely to an increasingly complex economy and business world. Rather, the tax laws themselves contributed to the complexity in the business world.

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[70] As of September 1993, a total of thirty-five states had already enacted statutes providing for limited liability companies. *The Limited Liability Company—An Emerging Business Form of Choice*, LXIV Corporation Guide (P-H) P 18.1 (Sept. 15, 1993). *See also*, *State-by-State Tax Treatment of LLCs Reviewed*, STATE TAX REVIEW (CCH) (Oct. 11, 1993).

[71] The IRS has not yet revised the regulations to adequately distinguish between S corporations and partnerships, which are similar, but differ in important respects. This task has already begun with respect to limited liability companies. *See, e.g.*, Rev. Proc. 92-35, 1992-1 C.B. 790.

B. *Tax Reform, Preferences, and the Rise in Complexity*

Much of the increased complexity in the tax laws resulted from the tax policymaking process itself, rather than from the external economic environment. It is often the case that 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 themselves caused much of the increased complexity in the federal income tax laws. Consider, for example, such tax reforms as the passive activity loss rules which were aimed at eliminating tax shelters. The passive activity loss rules were enacted by Congress to deal a death blow to the tax shelter industry once and for all.[72] The basic idea behind this reform was to prevent taxpayers from using losses generated from "passive" activities (that is, tax deductions from tax shelters and other passive investments) to offset income derived from either portfolio investments (dividends or interest income) or earned income (wages or self-earned income).[73] This approach appears relatively simple and straight-forward, but looks can be deceiving.

The problem, once again, was that the vague and overly-broad language introduced into the tax code in the burst of tax reformism proved to be useless against the planning of tax lawyers. It again fell to the tax experts at Treasury and the Service to provide through regulation that which was otherwise unattainable through statute. Unfortunately, the resulting passive activity loss regulations issued by Treasury are so comprehensive as to be incomprehensible to taxpayers, the judges who adjudicate disputes over the interpretation of the federal statute, and even most tax lawyers.

Introduced in successive sets of Treasury regulations, the passive activity loss regulations already amount to over five hundred of pages that must be navigated by any taxpayer involved in multiple investment activities. Indeed, the regulations require some forty pages just to define what is meant by an "activity"—a vital enterprise when it is

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[72] The passive activity loss (PAL) rules are found at I.R.C. § 469 (Law Co-op. 1993).

[73] Proposals had been formulated in the 1970s by Treasury tax experts to limit the use of artificial tax losses to shelter other ordinary income. However, such proposals were modest in scope compared with what was ultimately enacted in 1986. The concept behind the passive activity loss rules was first set out in legislation in 1983 by Senators Moynihan and Chafee, and later was reintroduced in the Senate tax reform bill.

remembered that the rules generally require a taxpayer to account for each such separate activity.[74] The increased complexity has even tempered the enthusiasm of those who initially saw the passive activity loss rules as the vehicle to tax "fairness."[75]

Some have argued that despite the inordinate complexity of the passive activity loss regulations, because they successfully shut down the tax shelter industry, the overall effect has been to simplify the tax laws.[76] Whether or not such is the genuine essence of tax simplification, the majority of taxpayers have never had to confront these technical rules simply because they do not invest in businesses in which they do not actively participate. However, for those who do, some of the most impenetrable and convoluted regulations await them.[77]

In much the same way, the original issue discount (OID) rules which were intended to prevent tax avoidance through deferral of the payment of tax[78] and the infamous Section 89 proposed regulations which were meant to prevent discrimination in the use of pension plans and other tax-favored benefits by management to the exclusion of workers. The Section 89 regulations imposed complex and incomprehensible rules on employers with respect to qualified retirement plans.[79] These regulations ultimately were withdrawn by the Internal Revenue Service in direct response to the significant public outcry against this

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[74] In an effort to simplify these regulations, the final regulations were shortened considerably, purportedly reducing the complexity of the rules. *See* Treas. Prop. Reg. § 1.469-4.

[75] *See, e.g.*, Stephen P. Allen, *Fixing The Passive Activity Loss Rules*, 50 TAX NOTES 1419 (Mar. 25, 1991) ("The PAL rules have been quite effective in dealing with tax shelters. Unfortunately, they have also produced a serious side effect: a substantial increase in tax law complexity. In making the tax system more fair, Congress has also made it more incomprehensible.").

[76] Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity be Reduced?*, 45 TAX L. REV. 97, 105-06 (1989) ("Notwithstanding the length and detail of the PAL rules, they represent a net simplification of the tax system. The success of these rules in eliminating complex tax shelter investments has simplified the investment decisions for most high income taxpayers."). Notwithstanding the implications of Professor Koppelman's statement, it is probably fair to say that most of the taxpayers who previously wrestled with complex tax shelter investments would gladly do so again if only given the opportunity.

[77] As one commentator has put it: "It is now three years after the enactment of the limitation on passive losses. And something is terribly wrong. From a simple idea to limit tax shelters there has developed a set of statutory rules and administrative regulations of immense complexity. The complexity of these rules is so great that most taxpayers will *never* be able to understand them." Richard M. Lipton, *PALs at Three: What We Know, What We Don't Know And What Went Wrong*, 67 TAXES 715 (1989) (emphasis in original); *see also* Richard M. Lipton, *PALS at Four: Living with the Regulations*, 68 TAXES 779 (1990).

[78] *See infra* notes 90-91 and accompanying text.

[79] I.R.C. § 89 (prior to 1989 amendment).

"regulatory nightmare."[80] These and other regulatory nightmares were originally conceived of as reforms and implemented to prevent abuses of the tax laws. However, they ultimately increased the complexity of the tax laws to the point where they nearly become dysfunctional—where taxpayers and the Service can no longer understand or apply the tax laws.[81]

The congressional tendency to implement more and more domestic policy through so-called "tax expenditures" is another significant development in tax policymaking that accounts for a large portion of the increased magnitude and complexity of the tax laws. Paul McDaniel has written that "the use of tax expenditures constitutes the single biggest cause of complexity in our tax system."[82] This may be something of an overstatement, but it is hard to quarrel with the assertion that tax expenditures contribute much to the increase in complexity of the tax code. Tax expenditures have been defined as "those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability."[83]

By the 1960s it was common practice to use tax credits and preferences to implement social and economic policy. The effort to incorporate so much 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 tax benefits and those who are perceived to be abusing these provisions. These distinctions inevitably require increasingly complicated rules and regulations. Social policies as diverse as encouraging "research and development"[84] and low in-

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[80] Pub. L. No. 101-40, § 203 (1989) repealed I.R.C. § 89. *See also* Elin Rosenthal, *Section 89 Foes Unimpressed by Treasury's Attempts at Compassion*, 42 TAX NOTES 528 (1989); Elin Rosenthal, *Sobering Thoughts Intrude on Eulogy of Section 89*, 45 Tax Notes 930 (1989).

[81] The tax laws become dysfunctional when they become unadministrable, and thus, no longer raise sufficient revenue due to the inability of even well-intentioned taxpayers to comply with them.

[82] Paul McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27 (1978).

[83] The Congressional Budget and Impoundment Act, Pub. L. No. 93-344, § 3(a)(3), 88 Stat. 298, 299 (1974). For a comprehensive discussion of the dynamics of the political process of legislating tax expenditures, see STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES (1973); STANLEY S. SURREY & PAUL R. MCDANIEL, TAX EXPENDITURES (1985); JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX, Chs. 14 and 15 (1985); JOSEPH A. PECHMAN, FEDERAL TAX POLICY 355-63 (1987).

[84] I.R.C. § 174 (Law. Co-op. 1993).

come housing[85] through tax credits, and providing deductions for charitable contributions[86] all contribute in their own way to increasing the burden imposed by the tax code.

While tax reformists have attacked the use of the tax system to implement policy, congressmen find the use of tax incentives 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, as radical a departures from traditional tax policymaking as that represented, made only a dent in the complexity resulting from these provisions. As the traditional tax policymaking has reasserted itself since 1986, the use of tax expenditures to make policy has increased again, thereby assuring that tax complexity will remain a salient feature of the federal income tax for the foreseeable future.

C. *Economic Analysis in the Tax Code*

The tax code also has grown in complexity as policymakers and the tax experts in the Treasury Department became increasingly sophisticated in perfecting the underlying 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.[87] 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 in order to eradicate perceived abuses of the tax rules (*i.e.*, avoidance of tax) 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, taxpayers once could purchase so-called "zero coupon" bonds or other corporate debt obligations and defer the receipt and taxation of the "interest" payable on such obligations until the date of maturity (or redemption).[88] Such deferral is viewed as unwarranted from the per-

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[85] I.R.C. § 42 (Law. Co-op. 1993).

[86] I.R.C. § 170 (Law. Co-op. 1993).

[87] *See, e.g.*, Treas. Reg. § 1.441-1(a) (each taxable year is a separate unit for tax accounting purposes).

[88] For a cash basis taxpayer, the interest income would not be taxed until actual or constructive receipt. *See* Treas. Reg. § 1.451-1(a).

spective of the Haig-Simons definition of income[89] in that the debtholder's economic position has been enhanced over the course of the year as much as if the interest had actually been paid, especially where the issuer is in sound financial condition and there is no reason to question its ability to satisfy the obligation to pay the accrued unpaid interest at maturity.

Accordingly the original issue discount (OID) rules were introduced in the 1980s, refining prior efforts to control this deferral of income recognition.[90] The OID rules impose taxation on the interest (and allow for a related deduction to the payer) based upon the concept of the economic accrual of the interest rather than upon its actual receipt. This may be sound policy if the sole objective of the tax laws is to ensure that taxable income replicates economic income. However, the OID rules introduced an extraordinary level of complexity into the tax laws by adding the economic accrual concept. If simplicity in the tax code is respected as one of the goals of tax policymakers, statutes such as the OID provisions must be considered a mixed blessing.[91]

Another example of how the introduction of economic analysis into the tax code contributed to an increase in the complexity of the tax laws was found in the campaign against "tax arbitrage" waged during the 1980s.[92] The simplest example of tax arbitrage arises when an investor borrows in order to invest in a tax-exempt municipal bond. Under prior tax law, the investor could deduct all of the interest paid to carry such a tax-preferred investment, while the interest income paid

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[89] "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of rights exercised in consumption between the beginning and end of the period in question." Henry C. Simons, *Personal Income Tax: The Definition of Income as a Problem of Fiscal Policy* 50 (1938). This "economic" definition of income formulated by Henry Simons, but generally referred to as the Haig-Simons definition of income in deference to economist Robert Haig's earlier contribution, posits that economic income is the sum of the accumulation of wealth and consumption over whatever period of time is adopted for purposes of measurement. For a discussion of the Haig-Simons definition of income, see Richard B. Goode, *The Economic Definition of Income*, in COMPREHENSIVE INCOME TAXATION 1-36 (Joseph A. Pechman, ed. 1977).

[90] The original issue discount rules are found at I.R.C. §§ 1271-75.

[91] The Treasury regulations interpreting the OID rules are 441 pages long and utilize extremely complicated economic concepts. In some cases it requires a computer to perform the computations required under the regulations.

[92] Tax arbitrage involves taking advantage of the differential rate of return on investments arising solely from the different tax treatment of different sources of income. *See* EUGENE C. STEUERLE, TAX DECADE: HOW TAXES CAME TO DOMINATE THE PUBLIC AGENDA, 30-33 (1992); David J. Shakow, *Confronting the Problem of Tax Arbitrage*, 43 TAX L. REV. 1 (1987).

on the investment would be exempt from income tax.[93] The result could be a profit derived solely from the differential created by the tax code itself. While this particular simple version of tax arbitrage is now disallowed under the tax code,[94] other forms still remain part of standard tax planning. For instance, investments in IRAs, Keogh plans, qualified ERISA plans, and deductions for home mortgage interest involve tax arbitrage opportunities available to most taxpayers.[95]

Each of the provisions that creates such an arbitrage opportunity is really nothing more than a tax preference enacted to encourage taxpayers to move their capital into favored activities. Tax complexity results when economic-minded reformers introduce provisions to the tax laws in order to limit the ability of taxpayers to benefit from the tax preferences that generate arbitrage opportunities.

D. *"Back-Stop" Tax Reform*

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 over-use of such tax preferences. In such instances, tax policymakers can be seen as rectifying their own poor judgment and excess generosity in enacting too many tax preferences in the first place. Charles McLure has referred to measures designed to limit the use of tax preferences as "back-stop" provisions intended to "prevent the abuse of tax preferences and/or the appearance of inequity . . . ."[96]

Through back-stop reforms, the tax laws necessarily become even more complicated as new provisions are introduced today to limit the

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[93] I.R.C. § 265 (Law. Co-op. 1993), added to the tax code in 1954, was enacted to prevent such a result by disallowing the interest expense incurred to acquire or "carry" tax-exempt obligations.

[94] This form of tax arbitrage is prohibited by I.R.C. § 265. Municipal governments used to engage in the reverse of this transaction. They borrowed at interest rates below market rates (on account of the interest-free treatment afforded such interest under I.R.C. § 103) and reinvesting the bond proceeds in higher yielding markets, with the interest income exempt under I.R.C. § 115 (exemption from federal income tax for "governmental entities"). This practice is now outlawed by I.R.C. § 148.

[95] Charles McLure points out that there are now more than a half dozen different types of "interest" in the tax code and various tracing rules designed to distinguish one form from another for tax purposes. MCLURE, *supra* note 5, at 63.

[96] *Id.* at 43.

applicability of yesterday's tax preferences. 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.[97] Incremental policymaking tends to produces only minor adjustments to existing tax policies, and back-stop reforms are highly compatible with such a strategy of policymaking.

Perhaps the best illustration of how incremental policymaking is conducive to back-stop reform was the introduction of the alternative minimum tax (the AMT).[98] Introduced in the Tax Reform Act of 1969, the AMT is a separate, parallel tax system to the "regular" federal income tax. It is an "add-on" tax intended to back-up or correct for the inadequacies of the federal income tax itself. This parallel tax system begins with a comprehensive tax base in which deductions attributable to those tax preferences deemed to be most abusive are added back to adjusted net income.[99] Under current law, "alternative minimum taxable income" is subject to a two-tier tax of 26% and 28% for individuals. It was originally introduced as a flat 10% rate and increased over the course of the next twenty-four years of incremental policymaking by a series of back-stop reforms.[100]

As the many preferences added to the tax code have accumulated over the years, taxpayers have utilized them to an increasing extent to reduce their overall tax liabilities. Not only is this all perfectly legal, but it is precisely what the statutes were "intended" to do—namely, induce individuals and corporations to engage in those economic activities or purchase those goods which were singled out by Congress as particularly worthy of subsidy.

The alternate minimum tax demonstrates how the tax law lends itself to incremental tax policymaking. It was politically easier for Congress to adopt this parallel tax regime, publicized as a reform, rather

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[97] To be somewhat more critical, the back-stop reform provisions reflect a lack of integrity. Measures that were once introduced as favorable to the enhancement of the public interest are recharacterized as abuses when taxpayers take advantage of the tax benefits previously offered by Congress. Examples include investment tax credits, accelerated depreciation, interest expense and the possessions tax credit under I.R.C. § 936.

[98] The alternative minimum tax is found at I.R.C. §§ 55-58.

[99] In computing alternative minimum taxable income, the taxpayer must add back deductions allowed for purposes of regular income tax such as certain interest deductions, depreciation and exemptions. *See* I.R.C. § 56.

[100] The latest rate increase, from a flat 24% to the aforementioned two-tier rate schedule, was implemented by the recently enacted Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, at § 1320, 107 Stat. 416 (1993).

than to sweep the tax preferences out of the tax code altogether. After all, if use of the tax preferences to reduce tax liabilities was the problem, then reducing or eliminating them from the tax code would be the logical solution.[101]

As such, the alternate minimum tax reflects the worst tendency of incremental policymaking—tinkering with change at the margins rather than confronting the underlying problems. And once a provision such as the AMT finds its way into the tax code, it is virtually impossible to repeal it other than in the enthusiasm of a massive tax reform effort such as occurred in 1986. Of course, even if repealed in such reformist's zeal, old provisions have a nasty habit of being recirculated as the next decade's reform. This was true of the investment tax credit which resurfaced only eight years after its most recent repeal in 1986.[102] Likewise, incremental policymaking succumbs too readily to the temptation to expand the scope of back-up reform provisions, as has been the case with the alternative minimum tax, both in terms of applying it to more tax preferences and in increasing tax rates for AMT. Because of this expansion of the back-up reform, more and more taxpayers now find themselves subject to the alternate minimum tax, although a high percentage of them apparently remain entirely unaware of the tax or their obligations and liabilities under this provision. Back-up reform provisions have once again contributed to tax law complexity in that they have created confusing statutes to which taxpayers do not adhere.

III. THE TAX GAME

One way to comprehend the dynamics behind the expansion in the complexity of the tax laws is to imagine the income tax laws as estab-

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[101] Some have suggested that the problem is "piggishness" in over-using tax preferences to reduce one's tax liabilities. The alternative minimum tax is the kind of solution put forth to impose "selective limitations" on such abuse of tax preferences. *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 attempting to determine when a taxpayer has over-used tax preferences inevitably results in one more set of complicated calculations which taxpayers will be forced to confront. The AMT has produced exactly this result.

[102] In his first State of the Union on February 17, 1993, President Clinton formally set forth his new economic program to Congress. This included a proposal to reintroduce the investment tax credit. The investment tax credit was first introduced in 1962, suspended briefly in 1966, terminated in 1969, reinstated in 1971, and finally abandoned pursuant to the Tax Reform Act of 1986. This proposal was ultimately dropped in the wake of much criticism. *See* Mortimer M. Caplin, . . . *And Drop Investment Tax Credits*, WALL ST. J., Mar. 29, 1993, at A12.

lishing a kind of game.[103] The tax laws create a vast edifice, complete with rules and procedures that must be followed by those who, for better or worse, are required to play.[104] As with any game, different strategies will produce superior outcomes, and in the course of playing the game over time these strategies become evident to the players themselves, and they will adapt accordingly. But the concern here is not so much the dynamics and logic of play—the subject of game theory—but rather with the development of the structures of the game and the impact of such development on the rules. Toward this end, consideration of the players' interests in playing the game sheds light on why the rules developed as they did.

The point of the tax game from the perspective of the taxpayer (or tax lawyer) is to minimize one's tax liability (or that of one's client) while complying fully with all of the rules directly on point. Of course, since the "rules" are really federal statutes buttressed by criminal sanctions, a failure to play by the rules can result in significant fines and imprisonment.[105] However, notwithstanding such penalties for failure to comply with the tax laws ("tax evasion"), there is no shortage of methods by which taxpayers can minimize or avoid taxation ("tax avoidance"). Indeed, it becomes quite evident rather early in the career of every tax lawyer that any business transaction can be structured in a number of different ways, and different tax consequences follow from different structures for the deal; this is true notwithstanding the doctrine enunciated by the Supreme Court that substance rather than form should dictate the characterization and taxation of a particular economic arrangement or transaction.[106]

As successive generations of taxpayers and lawyers confronted the tax laws, the rules of the game became apparent and the meaning, con-

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[103] This analysis of the tax system as a game can be traced to the seminal writings of Oskar Morgenstern and John Von Neumann. *See* THE THEORY OF GAMES AND ECONOMIC BEHAVIOR (1944). Among the first applications of game theory to social science were WILLIAM H. RIKER, THE THEORY OF POLITICAL COALITION (1962); JAMES M. BUCHANAN and GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962).

[104] The fact that taxpayers are forced to play the tax game does not affect the strategies or outcomes of play, nor is it particularly unusual that a game is coercive. For instance, William Riker analyzed the dynamics of the competitive relationship between the United States and the Soviet Union in terms of an involuntary "two-person" game. *See* RIKER, *supra* note 103.

[105] *See* I.R.C. §§ 7201, 7206, 7343 (criminal sections for tax evasion and fraud). *See* Sheldon D. Pollack, *The Penalty For Tax Fraud Against A Corporation*, THE TAX ADVISER 464 (July 1992); HARRY G. BALTER, TAX FRAUD AND EVASION (1983).

[106] CIR v. Court Holding Co., 324 U.S. 331, 334 (1945) ("The incidence of taxation depends upon the substance of a transaction. . . . [T]he transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant.").

sequences, and outcomes of particular sets of tax rules were revealed. Much of the initial "learning stage" of the game was played out between 1913 and 1919 during the first regime of the federal income tax. In any game, the level of play will rise to higher levels as players fully learn the range of moves possible under the rules.[107] Furthermore, as the players become more and more sophisticated in their play, the rules of the game also may be modified to counteract and balance the increased level of skill of the players. As a result, the game itself becomes more and more complex as it becomes highly institutionalized.[108]

It is impossible to predict *a priori* who will benefit from an increase in the complexity level of a game. For instance, in a game such as chess, the beneficiaries of the enormous complexity are those players with the greatest capacity to foresee the outcome of the possible successive moves of an opponent. In baseball, the progressive institutionalization of the game resulted in shifting the balance of power among the players.[109] In the early stages of the game, before the rules and logic of the game were fully revealed to players, hitters prospered. This was because players in the field had not yet fully "learned" their roles, meaning they had not yet mastered their play. Accordingly, hitters had what today would be considered improbably high batting averages from 1900 through the 1940's. Thereafter, players, especially the pitchers, became more proficient in their skills, and rules were changed with the express intention of restricting the success of hitters. One example was the raising of the pitching mound which resulted in batting average declines in the post-War era of the 1950s.[110]

In the tax game it is difficult to know with much certainty at any particular moment who is winning—the tax lawyers or the IRS. The dynamics of the tax game appear to be that once some clever tax law-

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[107] As every child quickly learns, the range of possible outcomes for the game of tic-tac-toe is too limited, and hence, play soon becomes boring. Likewise, checkers soon bores most players, although, in fact, there are millions of possible outcomes in checkers (as opposed to tic-tac-toe). It is just that the games all resemble each other, and thus, offer no great excitement.

[108] For instance, the U.S. House of Representatives became increasingly institutionalized throughout the course of the nineteenth century. The role of "representative" became more professional, decisionmaking became routinized and formal, leadership became hierarchical, and rules became more complex as the House became progressively institutionalized. *See* Nelson W. Polsby, *The Institutionalization of the U.S. House of Representatives*, 62 AM. POL. SCI. REV. 144 (1968).

[109] The following argument concerning the effects of institutionalization on baseball statistics, in particular batting averages, was put forth by Stephen Jay Gould, *Losing the Edge*, VANITY FAIR, March 1983, at 120.

[110] *Id.*

yer recognizes a new maneuver around a particular provision of the tax code, and uses it successfully to reduce the tax liability for a particular type of transaction, the maneuver quickly becomes known throughout the tax bar and the IRS eventually learns of it.[111] Thereafter, new regulations and perhaps even new statutes (the "rules" of the tax game) are adopted, shifting the advantage back to the taxing authorities for a period of time.[112] As this occurs, the rules of the game inevitably become a bit more complicated, and the tax lawyers must learn to play and devise new strategies under the new rules. The tax game is unusual in that one participant also acts as the referee of the competition, empowered to write new rules to favor its own side.[113] In such a game, it is not surprising that the rules grow ever more complex as the competitor/referee constantly rewrites the rules to its own advantage.

This increased complexity in the tax laws can result in greater uncertainty when the complexity of the rules of the tax game reach the point where players no longer understand them, and hence, cannot predict the outcome. In a variation on this theme, it has been suggested that a moderate level of tax complexity is desirable from the perspective of both the tax bar and the tax authorities.[114] According to this argument, higher levels of uncertainty increase the cost of litigation, and accordingly, increase the taxpayer's interest in pre-trial settlements which reduce the tax lawyers' fees. The IRS, too, generally favors moderately high levels of complexity which make for greater uncertainty, and impels taxpayers to comply with the tax laws, or upon audit, to settle their disputes (thereby maximizing revenue for the govern-

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[111] Because the tax experts in the Treasury Department and the IRS generally come out of private tax practice, these techniques of tax avoidance eventually become known to the taxing authorities. This should be seen as one benefit from the so-called "revolving door" between business and government officials.

[112] Examples of such new IRS regulations relate to the so-called "May Stores transaction" utilizing partnership distributions, the use of the Section 754 election to step-up basis in partnership assets in the context of a consolidated return, and the taxation of new complex financial instruments designed to take advantage of the treatment of contingent interest under the OID rules. *See, e.g.*, Treas. Reg. § 1.1275-4(g) (bifurcation of contingent debt instruments).

[113] In this respect the tax game is analogous to what would result were gambling casinos permitted to amend the house rules in response to success by gamblers in beating the odds — for instance, by banning "card-counting." Of course, state gaming officials can usually be persuaded to make such rule changes on behalf of the casinos.

[114] *See* Michelle J. White, *Why Are Taxes So Complex and Who Benefits*?, 47 TAX NOTES 341 (1990). A tax attorney in the film made from John Grisham's best-selling novel, THE FIRM, (1991), states this cynical view as follows: "It's a game. We teach the rich how to play it so they can stay rich — and the IRS keeps changing the rules so we can keep getting rich teaching them." Quoted by George Will, *The Tangle of Egos and Rules*, NEWSWEEK, July 26, 1993, at 60.

ment).[115] Presumably, the policymakers who create tax complexity, introduce complexity into the tax code, or at least tolerate it, to enhance the Treasury's collection of revenue under the income tax laws.

This kind of application of game theory to an analysis of the development of tax complexity focuses on the conflicting interests of the key players of the game in determining what they consider to be an optimal level of complexity with respect to the rules of the game. However, such analysis demonstrates the limits in applying game theory to the tax system. The analysis is useful in explaining the behavior of taxpayers, tax counsel, and the IRS in terms of elucidating the economic interests of the respective players. In doing so, game theory assumes that the players make decisions based upon a rational assessment of their own self-interests narrowly defined in terms of the maximization of their economic positions. However, when this analysis is applied to the political elites who actually make the rules of the tax game, it breaks down. When political elites are portrayed as "players" and their behavior is explained in terms of the calculation of economic and rational interests, the conclusion is that they will be revenue-maximizers, behaving as "predatory" rulers.[116] Similarly, a pure economic model will conclude that political elites will raise tax rates to "point E" on the so-called "Laffer" curve,[117] disregarding the interests of civil society.[118]

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[115] Accountants are said to benefit from high levels of complexity as well as it pushes taxpayers to seek professional advice in preparing their tax returns. According to one economist, for most U.S. corporations with assets of less than $1 million (constituting 90% of all U.S. corporations), the cost of compliance with the federal tax laws is significantly higher than their tax liabilities. *See* Arthur P. Hall, *Accounting Costs, Another Tax*, WALL ST. J., Dec. 9, 1993 at A16. A study by Professors Joel Slemrod and Marsha Blumenthal has estimated that for 1992, the total cost of compliance for the Fortune 500 companies amounted to $1.055 billion, or $2.11 million per company — seventy percent attributable to federal taxation, and the rest to state and local taxation.

[116] *See* Margaret Levi, *A Theory of Predatory Rule*, 10 POL. & SOC'Y 431 (1981). Levi presents the general thesis that "rulers are predatory in that they try to extract as much revenue as they can from the population." *Id. See also,* OF RULE AND REVENUE 3 (1988).

[117] The Laffer curve was put forth by supply-side economist Arthur Laffer, a member of President Reagan's Economic Policy Advisory Board, to show that at some hypothetical point on a curve comparing revenue with tax rates, revenue will reach a maximum ("point E"), and thereafter decline as tax rates increase further. *See* FOUNDATIONS OF SUPPLY-SIDE ECONOMICS: THEORY AND EVIDENCE (Victor A. Canto et al. eds., 1983); SUPPLY-SIDE PORTFOLIO STRATEGIES (Victor A. Canto & Arthur B. Laffer eds., 1988). For a discussion and assessment of the theories behind the Laffer Curve, see DAVID G. DAVIES, UNITED STATES TAXES AND TAX POLICY 61-68 (1985).

[118] It is an axiom of supply-side theory that revenue will decrease as tax rates increase beyond some hypothetical revenue-maximizing peak ("point E") on a curve comparing revenue with tax rates (the so-called "Laffer" curve). At point E, revenue will reach a maximum, and thereafter decline as tax rates increase further. For a critical discussion and assessment of the theories behind the Laffer Curve, see DAVIES, *supra* note 117, at 61-68.

Yet, it is clear that political elites do not behave this way. Such rational explanations take into account only pure economic motives such as revenue maximization and ignore all the personal and institutional motives and interests behind tax policymaking. For example, policymakers do not want to raise tax rates too high because they will have to answer to their constituents for the higher rates. In open and democratic politics, such as that which prevails in the Western democracies, political elites are continually subjected to popular controls exerted through electoral politics and the open expression of public opinion. Arguably, electoral competition and public opinion imposes a significant degree of popular control over political elites and renders them accountable to the citizenry in some fashion.[119] The interest of political elites in maximizing state revenue at the expense of overall economic growth can be tempered and restrained by electoral and popular pressures. The behavior of political elites forced to compete in elections for the right to hold office may be effectively checked and restrained even without the electorate understanding the specific details of this conflict of interest over marginal tax rates. Recent experience in American politics suggests that sharp increases in tax rates can provoke strong populist resistance that is quickly translated into restraints imposed on political elites through the mechanisms of democratic politics.[120]

Likewise, the impact of ideologies (such as tax reformism and the liberal political tradition itself) on the behavior of political elites is left out of game theory. So while game theory does offer insights into the dynamics of the tax game in which taxpayers, tax authorities, and tax lawyers all participate, it provides little insight into how and why the tax game developed over time. Ultimately, the political elites who are responsible for making the rules of the tax game (which account for

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[119] The seminal statement of this view of electoral politics is found in JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY (Ch. XXII, *Another Theory of Democracy*) 269-83 (1950). Robert Dahl built upon Schumpeter's theme, arguing that elections insure that "political leaders will be somewhat responsive to the preferences of some ordinary citizens." ROBERT A. DAHL, A PREFACE TO DEMOCRATIC THEORY 131 (1956). Others have suggested that elections also create a sense of legitimacy and stability that benefits political elites and the regime itself. *See, e.g.*, BENJAMIN GINSBERG, THE CONSEQUENCES OF CONSENT: ELECTIONS, CITIZENS, CONTROL AND POPULAR ACQUIESCENCE (1982); THE CAPTIVE PUBLIC: HOW MASS OPINION PROMOTES STATE POWER (1986).

[120] For example, consider the grass-roots, populist, anti-tax movement that began in California with Proposition 13. For a discussion of this anti-tax politics, see SUSAN B. HANSEN, THE POLITICS OF TAXATION: REVENUE WITHOUT REPRESENTATION (Ch. 7 - *The 1978 Tax Revolt: Causes and Consequences*) 212-50 (1983).

the increased complexity) are driven by much more complicated motives and interests than what is assumed by game theory.

IV. TAX REFORM: TAX SIMPLIFICATION?

A. *The Consumption Tax: Changing the Tax Game?*

Notwithstanding the many significant efforts to reform the tax laws over the course of the past decades, the tax code has only become more complex and confusing. Such "innovations" as the alternative minimum tax only add to the complexity of the tax law without really addressing the underlying factors behind the perceived problems.[121] The result is that the problems of the old system are preserved while new problems are created as the reform provisions are inadequately integrated into the present tax regime.

While incremental policymaking so often results in back-stop reforms that clutter the tax code with ever greater complexity, the lesson of 1986 is that occasionally an extraordinary political coalition can succeed in breaking out of the pattern of incrementalist policymaking. Such radical departures from "politics as usual" and incrementalism are rare in tax policymaking. Indeed, the 1986 Act may be the only example in our experience.[122] But, as the tax code becomes more complex and cumbersome, it may eventually reach the point where the tax system can no longer raise revenue efficiently[123] and compliance with

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[121] *See* discussion *supra* part III.D.

[122] *See, e.g.*, STEUERLE, *supra* note 36, at 1 ("By mid-1984, analysis and debate on major tax reform was underway, culminating in the Tax Reform Act of 1986—the most comprehensive reform of U.S. tax laws ever undertaken."); John F. Witte, *The Tax Reform Act of 1986: A New Era in Tax Politics?* 19 AMERICAN POLITICS QUARTERLY 438, 441 (Oct. 1991) ("TRA can only be viewed as a remarkable legislative accomplishment and by far the most radical example of peacetime tax reform in history."); Daniel Shaviro, *Beyond Public Choice and Public Interest: A Study of the Legislative Process as Illustrated by Tax Legislation in the 1980s*, 139 U. PA. L. REV. 1, 5 (Nov. 1990) ("[T]he 1986 Act was the all-time leading example of tax reform.").

[123] Increasing complexity and the inability to simplify the tax laws may eventually result in some form of system failure:

> Because of the scope of tax reduction provisions and the complexity of the code, it is doubtful . . . that the income tax can meet potential revenue needs in the future . . . [or] that it can be "reformed" to expand the tax base and/or simplify the system. Thus, the radical nature of change over time and the inability of the system to resist change create a policy morass that is perpetuated by its own structure.

WITTE, *supra* note 33, at 20. Even if Witte was overly pessimistic in his assessment of reform efforts to expand the tax base, he was correct in viewing the complexity of the tax code as a the tax laws will decline.[124] Such developments could increase pressures for a radical restructuring of the tax code.

As the legitimacy and revenue-raising capacity of the federal income tax have been questioned over the past decades, there has been considerable interest in abandoning the federal income tax scheme altogether in favor of an alternative tax system. This sentiment is reflected in academic proposals for various forms of a consumption tax. Dumping the federal income tax in favor of a national consumption tax would be the ultimate form of tax "reform" - abandoning all the tax expenditures, back-stop reforms and special interest provisions accummulated over the course of the eighty-year history of the income tax. Additionally, such a radical change would have a major impact on the practicing bar. A good deal of the expertise of the tax bar gained from eight decades of experience under the federal income tax would be negated as a new tax game, complete with its own rules and dynamics, took its place. While there is little likelihood that the federal income tax will be abandoned soon, or even that a national consumption tax will be introduced as a supplement to the income tax, such proposals are no longer matters of mere speculation among tax academics. The consumption tax has emerged on the political agenda.[125]

The primary argument of proponents of a consumption tax rests upon the assertion that there are advantages to be derived from taxing consumption rather than income. The notion is that the present tax regime taxes "income," including the return on investment capital and thereby creates disincentives for savings and incentives for consumption. This taxation of savings, it is argued, is unwanted in an economy that on one hand depends upon capital formation from the investment of savings and simultaneously saves relatively little. This is not a new observation.[126] However, the appeal of the argument has increased in

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potential cause of system failure. A four trillion dollar national debt is one good indicator that the tax system is already reaching that point.

[124] There is merit in the argument that the increased complexity of the tax laws has resulted in less compliance, and hence less revenue for the Treasury. *See, e.g.*, Eugene Carlson, *Tax Compliance by Small Businesses Eroded in the '80s*, WALL ST. J., June 27, 1991, at B-2, (quoting former I.R.S. Commissioner Fred T. Goldberg, Jr. from testimony before the House: "We believe that most noncompliance is unintentional. Much of it is due to the complexity of the tax laws.").

[125] Numerous bills have been in the works for the introduction of a national consumption tax. None have actually been reported out of the House Ways and Means Committee for a vote on the floor of the House.

[126] *See, e.g.*, THOMAS HOBBES, LEVIATHAN PART II, chap. 30 (1651): "For what reason is there, that he which laboreth much, and sparing the fruits of his labor, consumeth little, should be

recent decades as the U.S. economy has failed to achieve satisfactory levels of savings and investment.

There are many different variations of consumption taxes.[127] Examples of different versions of consumption taxes include excise taxes, sales taxes, the value-added tax (VAT) and expenditure taxes. Excise taxes are imposed upon particular commodities (*e.g.*, cigarettes, alcohol, gasoline, or such luxury items as yachts or furs). Sales taxes are imposed upon sales of broad categories of commodities or services, and are generally collected by the seller. The VAT is a common form of national taxation in Europe, and also was recently adopted by New Zealand and Canada (in the case of the latter, in the form of the Goods and Services Tax adopted in 1991).[128] This type of tax is imposed upon the value added to a particular commodity by the businesses engaged in the various stages of the manufacturing process. (Thus, the tax essentially is imposed upon the difference between the business's sales and its purchases.) The basic feature of all these taxes (sales, excise and VAT) is that they are ultimately imposed upon the consumption of goods and services, rather than on savings.

An expenditure tax is a consumption tax that essentially is imposed upon individual consumers, rather than upon sellers or manufacturers. An expenditure tax may be structured following a "cash-flow" model in which taxation is imposed upon net consumption of the individual over the accounting period.[129] One of the purported advantages of taxing "consumption" is that it results in greater "equity."[130] The notion is that an individual's consumption presents a fairer base for taxation than income. Others argue that consumption taxes are simply more "efficient" with respect to avoiding distortions in the formation of capital (an argument commonly made by economists).[131] On the other

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charged, more then he that living idley, getteth little, and spendeth all he gets; seeing the one hath no more protection from the Commonwealth then the other?"

[127] For a broad discussion of various forms of consumption taxes, see JOSEPH A. PECHMAN, FEDERAL TAX POLICY (Ch. 6 - *Consumption Taxes*) (1987); see also NICHOLAS KALDOR, AN EXPENDITURE TAX (1955); ECONOMIC CHOICES 1984 (Alice Rivlin ed. 1981); DAVIES, *supra* note 117, at 77-90.

[128] The Canadian Goods and Services Tax, Bill C-62, effective January 1, 1991, replaced the federal sales tax in Canada.

[129] *See* William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113(1974).

[130] *See, e.g.*, Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L. REV. 1081 (1980).

[131] This perspective is reflected in PECHMAN, *supra* note 100; Joseph Bankman & Thomas Griffith, *Is The Debate Between an Income Tax and a Consumption Tax a Debate About Risk?*

hand, some argue that consumption taxes are "regressive" since consumption by lower income individuals represents a higher percentage of their income than it does for wealthy individuals. This problem, if it indeed is a problem, can be solved through an expenditure tax, which can include a progressive tax rate structure.

In the end, however, perhaps the most significant obstacle to adopting an expenditure-styled consumption tax is the great difficulty in phasing out the present income tax and phasing in a consumption tax.[132] The problem arises because savings previously taxed under the old tax regime (savings in after-tax dollars) must be identified and provided with some form of exemption under the new regime; otherwise, these dollars would be taxed a second time if they are subsequently consumed. Proponents recognize such problems, but often dismiss them as solvable. However, if there is some extended period during which the new tax is phased in while the income tax is phased out, there will be two tax regimes which taxpayers must follow and plan around. Accordingly, since a radical break with the past is impossible, the tax scheme in effect during the transition period would be even more complex than the current system since two tax systems (three if the alternative minimum tax is counted) would be in place. For this reason, the problems from introducing a consumption tax into an economy already governed by an income tax regime are much greater than those confronted by nations with developing, emerging economies that have never had an income tax.[133] In such cases, the choice of a consumption tax as opposed to an income tax is considerably more appealing. However, introducing a consumption tax into an economy having eighty years of experience with an income tax would be far more problematic.

Because of the difficulty in implementing an expenditure-type consumption tax, excise-type consumption taxes have been more commonly used in recent decades as revenue enhancers to complement the federal income tax. For example, excise taxes have recently been imposed on luxury items such as yachts and high priced imported automobiles, and have been proposed for gasoline and energy consumption. Such taxes are more conducive to incremental policymaking and can be more easily grafted onto the current tax regime.

Does It Matter? 47 TAX L. REV. 377 (1992). Supply-side economists also favor consumption taxes to the extent they encourage savings.

[132] McLure identifies transition rules as one source of the complexity of the tax laws. *See* MCLURE, *supra* note 5, at 51.

[133] *See, e.g.*, Charles A. McLure, Jr. & George R. Zodrow, *Implementing Direct Consumption Taxes In Developing Countries*, 46 TAX L. REV. 405 (1991).

B. *The Problem of Complex Tax Laws*

While there has been much concern of late with a tax code that is beyond the ability of the "average" taxpayer to comprehend, little has been said to identify precisely the problem caused by such complex tax laws. Rather, it is simply generally assumed that because the tax code is complex, there must be a problem.

Such a simplistic position is powerless against the retort that most of the complexity of the tax code is seldom confronted by the average taxpayer, who generally files a simple Form 1040, or more likely, Form 1040-EZ (the "easy" version of the individual return for those in the unenviable position of having few deductions to claim). Presumably, if most of the tax law complexity affects only wealthy taxpayers and businesses for whom hiring professional tax advisers is standard procedure, there really is no problem with the many complex provisions of the tax laws. In other words, complexity is a problem only if it reaches the middle class.

To the extent that the computation of tax liabilities, filling out forms and satisfying the multitude of filing requirements can be simplified for a majority of individual taxpayers, as it was by the 1986 Act,[134] even while businesses and wealthy taxpayers confront increased complexity, political expediencies very well may be satisfied. That may be sufficient to alleviate the pressures on policymakers. But there is something cynical about the view that tax complexity is a problem only if felt by the average taxpayer for it misperceives the nature of the problem of complexity in the tax laws.

Recordkeeping is burdensome and confusing for the taxpayer, and the ability of the average taxpayer to understand the fundamentals of the tax law and prepare his or her own tax return is a prerequisite for effective tax policy.[135] But the focus of tax reform should not be on simplifying the preparation of tax returns. Simplification of preparation is usually accomplished by eliminating tax deductions or imposing

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[134] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 11 (1987) (stating that "[S]implification of the tax code itself is a form of tax reduction. . . . The Act reduces the complexity of the tax code for many Americans. . . . Taxpayers who will use the standard deduction rather than itemize their deductions will be freed from much of the recordkeeping, paperwork, and computations that were required under prior law.").

[135] *See, e.g.*, Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*," 45 TAX L. REV. 121, 166-67 (1989) (discussion of how complex recordkeeping requirements breed noncompliance).

threshold requirements (such as adjusted gross income) which most taxpayers will be unable to satisfy, and therefore, they will not be permitted to use a particular deduction.[136] Such a notion of simplification will be of little comfort to those who lose the benefit of the deduction.

The reasons for tax simplification go beyond the difficulty of filling out tax returns and computing deductions. The present system of taxation has contributed much to the bureaucratization of modern life and the increased regulation of economic life, for both individuals as well as businesses. Those unsympathetic to the problem of government overregulation of business should recognize that an overly complex tax system also adversely affects individuals.[137]

The tax laws have a peculiar impact upon 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. For example, a 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. Tax liability creates a disincentive to transacting one's business activities in that particular form just as surely as if there were an outright legal prohibition against such conduct. In this respect, the tax laws seem to be exempt from a traditional tenet of the liberal political tradition—specifically, the rule of law.[138]

The rule of law assumes that citizens are governed by clear legal standards, and that these standards are enunciated prior to taking effect, thereby providing citizens with notice of prohibited behavior and

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[136] For instance, see the discussion of tax simplification in STEUERLE, *supra* note 36, at 136-37 ("Among the major simplifications achieved by tax reform was the elimination of record keeping and tax calculations for those no longer eligible for certain deductions.").

[137] Speaker of the Virginia Senate, Richard E. Byrd (1910), in opposition to ratification of the Sixteenth Amendment, gave the following prophetic warning of the dangers of a national income tax: "A hand from Washington will be stretched out and placed upon every man's business; the eye of the Federal inspector will be in every man's counting house. . . . The law will of necessity have inquisitorial features, it will provide penalties, it will create complicated machinery. Under it men will be hailed into courts distant from their homes. Heavy fines imposed by distant and unfamiliar tribunals will constantly menace the tax payer. An army of Federal inspectors, spies and detectives will descend upon the state [of Virginia]. . . . Who of us who have had knowledge of the doings of the Federal officials in the Internal Revenue service can be blind to what will follow?" BLAKEY and BLAKEY, *supra* note 12, at 70.

[138] The classic statement of the principle of the rule of law is found at FRIEDRICH A. HAYEK, THE CONSTITUTION OF LIBERTY 162-75 (1960).

the sanctions attached to violations of these rules. 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. 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 means that the legal standards enunciated thereunder cannot be comprehended by those subject to sanctions for a failure to comply. Perhaps the best expression of the case against overly complex and changing laws is found in an oft-quoted passage from James Madison in *The Federalist*:

> 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?[139]

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. In many respects, this has become the sad state of tax policymaking.

CONCLUSION

The tax law should develop through judicial construction of generally stated principles laid out by Congress in the tax laws, rather than through "ever more complicated prescriptive rules"[140] made by tax bureaucrats. Unfortunately, the tax laws have developed over the course of the past decades in entirely the opposite direction. The tax code has become a massive and impenetrable edifice of rules and regulations that describe and govern nearly all spheres of economic life and business activity.

Reform legislation such as the Tax Reform Act of 1986 only added new complexity to the tax code even while purporting to achieve

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[139] THE FEDERALIST NO. 62, at 381 (James Madison) (New York: New American Library, ed., 1961).

[140] Peter C. Canellos, *Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott*, 45 TAX LAW. 1, 14 (1991).

an aesthetically purer income tax. Provisions enacted in 1986 contributed additional complexity as policymakers were required (first in statutes, and later in administrative regulations) to draw increasingly subtle distinctions between what is allowed and what is disallowed. Such over-legislating, aptly described as "hyperlexis,"[141] threatens to swamp the tax code with the accumulated weight of such subtle distinctions.

One consequence of excessive complexity in the tax laws is that it periodically stimulates demands for simplification of the federal income tax. Tax simplification has been championed by politicians, academics, bureaucrats, and even at various times the tax bar itself. The issue of overly complex tax laws also raises a number of important philosophical issues that are beyond the scope of the immediate inquiry. Nevertheless, these concerns should be kept in mind as the impact of tax policy upon the broader American political system is considered.

What are the implications for domestic policymaking when the tax code becomes overly complex? What is the underlying political agenda of those seeking specific reforms, such as closing loopholes or abolishing tax shelters? How are individual taxpayers (the citizens comprising the political community) and their rights and liberties affected by an almost incomprehensible system of tax laws, regulations, and rule by tax bureaucrats? Are there limits to how far the tax administrative state should intrude into the lives of individual taxpayers (as well as corporations and businesses) to raise maximum revenue from the tax laws? Or to achieve an "aesthetically" pure tax code?

These are the kinds of questions that we will need to collectively grapple with through political discourse as the tax laws increase in complexity and tax policy plays such an important role in contemporary American politics.

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[141] The term was defined as "a pathological condition caused by an overactive law-making gland." Bayless Manning, *Hyperlexis: Our National Disease*, 71 NW. U. L. REV. 767, 767 (1977). Manning wrote: "Statutory codes, such as those in the fields of commercial law and taxation, are becoming ever more particularistic, longer, more complex, and less comprehensible. We are drowning in law." *Id.*