

# THE E.L. WIEGAND LECTURE:\*

## ADMINISTRABILITY-BASED TAX SIMPLIFICATION

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The Boyd School of Law is a vibrant place, and our trajectory continues to move strongly in the right direction. One of the things that has been so important to us is the excellent support we have received from so many in and around Nevada. An example of that support brings us together tonight. The Wiegand Foundation has endowed a professorship at the Law School to support the study of tax law. I am fortunate to be the current holder of that professorship. This address is the first formal event memorializing the Wiegand Foundation's support for scholarship and for Law School. My thanks and the School's thanks to the Wiegand Foundation for its support and for what that support will enable.

Our topic is simplification of the federal tax law, particularly the federal income tax. Simplification has been called the "Holy Grail" of tax policy.<sup>1</sup> Like the Grail, simplification is both important and elusive. Quests for both are easy to start but difficult to bring to successful conclusion. We will consider the topic from five perspectives. First, the federal income tax is now our main tax, and it probably will continue to be. So, our attention should be on fixing the income tax to the greatest extent possible. Second, in fixing the income tax, simplification should be a high priority. Third, effective simplification requires putting heavy emphasis – far more than it receives today – on administrability. Fourth, we'll consider precedents: examples of administrability-based income tax provisions already in the Code. Finally, I'll offer three administrability-based simplifying income tax reforms that could be effected immediately.

### I. PERSISTENCE OF THE INCOME TAX AND NEED FOR REFORM

Federal taxation is an enterprise of awe-inspiring scale. Each year, the federal government raises over \$2 trillion in taxes. Over sixty percent of that comes from the income tax, combining the individual and corporate income tax.<sup>2</sup>

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\* On April 22, 2003, the author delivered an address at the William S. Boyd School of Law to inaugurate the E.L. Wiegand Professorship. This article is based on that address.

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<sup>1</sup> Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267.

<sup>2</sup> For Fiscal Year 2002, the United States collected about \$2,017,000,000 in total taxes. About 51.5% of that was individual income tax, and 10.5% was corporate income tax. Internal Revenue Service, 2002 DATA BOOK 8, tbl.1, col.3.

In recent decades, many in politics and academia have proposed what is often called fundamental tax reform, i.e., replacing all or much of the federal income tax with some other type of tax.<sup>3</sup> Often, the candidate substitute has been a consumption-based tax, such as a national sales tax, a value-added tax, or a flat tax that exempts savings.<sup>4</sup> These proposals have come from both sides of the political aisle.<sup>5</sup> Various advantages have been claimed for the proposed alternatives, including simplification.

It is always desirable to re-test basic premises; thus, such discussions and proposals have their use. However, we should not become overly excited about the proposed alternatives. The cold, hard truth of the matter is that these proposals likely will not see enactment. Something like the current federal income tax is and probably will continue to be the federal government's principal tax far into the future.

This prediction will be emotionally deflating for some. Americans love change (or at least the idea of change), and striking out for bold, new frontiers is exhilarating. William Archer, a former chair of the House Ways and Means Committee, was fond of saying that his objective was to "tear the income tax out by its roots."<sup>6</sup> Such a declaration is heady stuff. A guaranteed applause line. Bracing, in the way Martin Luther's "Here I stand" was bracing.

But, in the toll of years, the income tax outlasted Chairman Archer, and it probably will outlast others of like mind. Chairman Archer has been out of Congress for years now, but the income tax is still here, roots and all. In American tax policy, hard realities end to survive rhetorical exuberance.

At this juncture, I am uncomfortably aware of conflicting pulls: the aspirational versus the pragmatic. I am no fan of the too often bizarre, incomprehensible, and perverse composite that our income tax has become. So, ambitiously, I too want to see, and will work for, fundamental reform.<sup>7</sup> But the

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<sup>3</sup> Among the early important works, see William D. Andrews, *A Consumption-Type or Cash Flow Personal Income Tax*, 87 HARV. L. REV. 1113 (1974); Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?*, 89 YALE L.J. 1081 (1980). Some of the leading examinations of fundamental tax reform are excerpted in PAUL L. CARON, KAREN C. BURKE & GRAYSON M.P. MCCOUCH, *FEDERAL INCOME TAX ANTHOLOGY* pt. VIII (1997).

<sup>4</sup> For a description of some of the candidates, see WILLIAM W. OLIVER, *WHY WE SHOULD ABOLISH THE INCOME TAX: A GUIDE TO THE PRINCIPAL PROPOSALS* chs. 20-23 (1995); John K. McNulty, *Flat Tax, Consumption Tax, Consumption-Type Income Tax Proposals in the United States: A Tax Policy Discussion of Fundamental Tax Reform*, 88 CAL. L. REV. 2095, 2112-15 (2000).

<sup>5</sup> On the Democratic side, proponents of fundamental tax reform have included Jerry Brown, Dick Gephardt, Bill Bradley, and Sam Nunn. On the Republican side, proponents have included Jack Kemp, Bob Dole, Steve Forbes, Paul O'Neill, Dick Armey, Billy Tauzin, Richard Lugar, and Pete Domenici.

<sup>6</sup> Quoted in Howard Gleckman, *Tax Reform Is Coming, Sure. But What Kind?*, BUS. WK., June 12, 1995, at 87. Many others, enamored by this "sound bite," have adopted it or a similar locution. E.g., Frank James, *GOP Hopefuls Try to Court Anti-Tax Conservatives*, CHI. TRIB., Sept. 24, 1995, at 11C (Richard Lugar); Michael Prowse, *Flat Tax Frenzy: Republicans Are Querying the Fairness of Multiple Tax Rates and Seeking Reforms to Encourage Savings and Investment*, FIN. TIMES, Jan. 22, 1996, at 16 (Jack Kemp); David Tell, *Second Thoughts on the Flat Tax*, WKLY. STANDARD, Nov. 10, 1997, at 11 (Steve Forbes).

<sup>7</sup> My ideal outcome is a combination of major taxes. It would (i) substitute a value-added tax for the income tax as the main federal tax paid by most Americans, (ii) retain a stream-

pragmatic considerations described below – the reasons why something like the current income tax is likely to prove hardy – suggest that it would be unwise to put all of one's intellectual, emotional, and political "eggs" in the one basket of fundamental reform.<sup>8</sup>

While hoping and working for fundamental reform, we should not neglect efforts to improve what we have now and are likely to continue to have well into the future. Through such a dual-track strategy, we honor both the aspiration that cries for grand change and the pragmatism that prudently counsels feasible change. Here are five reasons why some version of the income tax likely is here to stay.<sup>9</sup>

First, the income tax produces a lot of revenue each year (as noted previously), and it does so with substantial predictability and reliability. We do not know with similar confidence how much some new, substitute regime would produce.

Revenue projections for a new system could greatly undershoot or greatly overshoot the mark. In the one case, the new system would produce too much tax and too great a drain on the economy. In the other case, it would cause a revenue shortfall that would either crimp federal programs or necessitate substantial deficit spending. These possibilities would be particularly great in the early years of the new regime, before experience improved prediction. But we already have such experience with the income tax. The revenue risks associated with trying to re-create that experience, as to any new system, should give considerable pause.

Second, the federal income tax is highly progressive.<sup>10</sup> Its progressivity has been flattened somewhat by recent legislation,<sup>11</sup> but it remains considerable. The proper degree of progressivity for our tax system has long been debated, and it remains controversial today.<sup>12</sup> Nonetheless, most Americans

lined income tax for high-income taxpayers, (iii) have a revised wealth-transfer tax (*see infra* note 56) payable only by the "super" rich, and (iv) keep employment taxes but reduce their rate if fiscally practicable. For generally similar proposals, see Thomas F. Field, *The Emperor Has No Clothes*, 102 TAX NOTES 1125 (2003); Michael J. Graetz, *100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System*, 112 YALE L.J. 261 (2002).

<sup>8</sup> See, e.g., Katie Gilchrist, *JEC Economist Says Consumption Tax Good Idea, in Theory*, 102 TAX NOTES 1274-75 (2003) (citing Diane Rogers, principal economist for the Joint Economic Committee). For a more optimistic assessment of the prospects for fundamental reform, see Edward J. McCaffery, *Ten Facts About Fundamental Tax Reform*, 102 TAX NOTES 1463 (2003).

<sup>9</sup> The income tax will not be stagnant, of course. Major income tax changes are made often, indeed too often for the health of the system. See, e.g., Steve Johnson, *The 1998 Act and the Resources Link Between Tax Compliance and Tax Simplification*, 51 U. KAN. L. REV. 1013, 1050-51 (2003). Frenetic amendment will change important aspects of the income tax. My prediction is only that the income tax as a whole is likely to persist in broadly recognizable form.

<sup>10</sup> See, e.g., JOEL SLEMRUD & JON BAKIJA, *TAXING OURSELVES* 71-75 (2d ed. 2000) (citing data from Congressional Budget Office and Treasury Department Office of Tax Analysis).

<sup>11</sup> See, e.g., William G. Gale, *The President's Tax Proposal: First Impressions*, 99 TAX NOTES, 265, 266-68 (2003); William G. Gale & Peter R. Orszag, *The President's Tax Proposal: Second Thoughts*, 99 TAX NOTES, 605, 606-07 (2003).

<sup>12</sup> Among the classics in the debate are WALTER J. BLUM & HARRY KALVEN, JR., *THE UNEASY CASE FOR PROGRESSIVE TAXATION* (1953), and CHARLES O. GALVIN & BORIS I. BITTKER, *THE INCOME TAX: HOW PROGRESSIVE SHOULD IT BE?* (1969). More recent contri-

believe that, to some substantial degree, the affluent should bear higher tax rates than the less affluent.<sup>13</sup>

Many of the widely discussed alternatives to the income tax are proportional or regressive in nature.<sup>14</sup> They could be made progressive through various modifications, but such modifications would decrease revenue and considerably complicate the systems.<sup>15</sup> Absent satisfactory solution of the distributional problems, there would be serious opposition to replacing the income tax.<sup>16</sup>

Third, every tax system produces economic winners and losers. People know what the economic effects of the current income tax are, and all sectors of business have adjusted to it. Indeed, tax assumptions are built into most transactions and decisions in our economy.<sup>17</sup> In contrast, no one would know for sure what the economic effects of some alternative tax system would be.<sup>18</sup>

This would have two consequences. First, some political opposition would develop to an alternative that might emerge as a serious candidate for enactment. The opposition surely would include companies and individuals who perceive that they would do worse under the new system than the old. It also might include those unsure of how they would fare—a “the devil you know is preferable to the devil you don’t know” theory. Second, there could be adverse economic effects. Tax uncertainty inhibits business deal-making. Major tax changes, and even major tax proposals, have caused economic chaos in the past. For example, the chair of the Senate Finance Committee suggested

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butions to the debate include Martin J. McMahon, Jr. & Alice G. Abreu, *Winner-Take-All Markets: Easing the Case for Progressive Taxation*, 4 FLA. TAX REV. 1 (1998); Barbara H. Fried, *The Puzzling Case for Proportionate Taxation*, 2 CHAP. L. REV. 157 (1999); Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU L. REV. 99 (2003); Michael A. Livingston, *Blum and Kalven at 50: Progressive Taxation, “Globalization,” and the New Millennium*, 4 FLA. TAX REV. 731 (2000).

<sup>13</sup> See, e.g., MICHAEL J. GRAETZ, *THE U.S. INCOME TAX* 11 (1999); SLEMRD & BAKIJA, *supra* note 10, at 61-64; William Safire, *The 25% Solution*, N.Y. TIMES, Apr. 20, 1995, at A19.

<sup>14</sup> See generally EDWARD J. McCAFFERY, *FAIR NOT FLAT* (2003); Steven A. Bank, *The Progressive Consumption Tax Revisited*, 101 MICH. L. REV. 2238 (2003).

<sup>15</sup> See, e.g., George K. Yin, *Accommodating the “Low-Income” in a Cash-Flow or Consumed Income Tax World*, 2 FLA. TAX REV. 445 (1995); Michael J. Graetz, *Implementing a Progressive Consumption Tax*, 92 HARV. L. REV. 1575 (1979).

<sup>16</sup> See, e.g., Field, *supra* note 7, at 1126-27.

<sup>17</sup> As an example, “our modern financial world has come to rely heavily on the [federal income] tax return” as verification to facilitate an array of transactions, such as loans, program eligibility, alimony, and child support. William J. Turnier, *PAYE as an Alternative to an Alternative Tax System*, 23 VA. TAX REV. 205, 210-11 (2003). “While this, in and of itself, hardly justifies the retention of an income tax, it does indicate the degree to which we undervalue this significant ancillary role of the tax.” *Id.*

<sup>18</sup> See, e.g., Julie Roin, *The Consequences of Undoing the Federal Income Tax*, 70 U. CHI. L. REV. 319 (2003) (discussing adverse effects on health care, pensions, homeowner equity, and state and local governments of replacing the income tax with a consumption tax). In addition, as to effects on the not-for-profit sector, see Evelyn Brody, *Charities in Tax Reform: Threats to Subsidies Overt and Covert*, 66 TENN. L. REV. 687 (1999); Charles T. Clotfelter & Richard L. Schmalbeck, *The Impact of Fundamental Tax Reform on Nonprofit Organizations*, in *ECONOMIC EFFECTS OF FUNDAMENTAL TAX REFORM* 211 (Henry J. Aaron & William G. Gale eds., 1996).

that a proposal to sunset the income tax at the end of 2002 would "create pandemonium in the marketplace."<sup>19</sup>

Fourth, the adverse effects of replacement could be mitigated by transitional rules. However, there would have to be an extensive array of such rules, and that would be problematic in itself. Extensive transitional rules would be politically contentious, revenue imperiling, highly complex, and fraught with the potential for unfairness.<sup>20</sup> The very difficulty of constructing the transitional rules is a significant barrier to replacing the income tax.<sup>21</sup>

My final reason is particularly relevant to the flat tax. Flat tax plans vary in important details,<sup>22</sup> but their core is easily stated: low and wide. That is, by eliminating many deductions and exclusions, the flat tax would considerably widen the tax base. It would then apply to that base a single tax rate (or a few compressed rates) considerably lower than the current top income tax rate.<sup>23</sup>

Whatever enthusiasm one might at first feel for this approach is considerably dimmed by the realization that the flat tax would not remain flat for very long. The current income tax did not begin as a monstrosity;<sup>24</sup> it became so over time. Congress responded to pressures from the electorate at large, key constituents, and large campaign contributors by enacting numerous relief mechanisms, subsidies, and preferences. At other times, Congress reacted to fears of revenue erosion by enacting numerous anti-abuse rules. These pressures would not magically disappear in a Bright New Day after enactment of a flat tax. As future Congresses yielded to them, the flat tax would soon become hilly, then ruggedly mountainous.

Two items of history support this prediction. First, after massive labor, the Reagan Administration and Congress brought forth the Tax Reform Act of 1986.<sup>25</sup> The Act actually achieved considerable simplification, through reduc-

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<sup>19</sup> William Roth, quoted by Ryan J. Donmoyer, *With Work Piling Up, Senate Debates Tax Code Termination*, 80 TAX NOTES 521 (1998) (discussing the Tax Code Termination Bill passed by the House of Representatives but not by the Senate).

<sup>20</sup> See, e.g., *Apache Bend Apartments, Ltd. v. United States*, 964 F.2d 1556 (5th Cir. 1992), *rev'd en banc*, 987 F.2d 1174 (5th Cir. 1993) (noting fairness problems as to tax transitional rules but denying judicial remedy therefor).

<sup>21</sup> For further discussion of the transitional rule problem, see SLEMROD & BAKIJA, *supra* note 10, at 177-80; Avishai Shachar, *From Income to Consumption Tax: Criteria for Rules of Transition*, 97 HARV. L. REV. 1581 (1984); Graetz, *supra* note 15.

<sup>22</sup> For example, the plan advanced by Dick Armey, former House majority leader, would have substantially curtailed the capitalization requirement by permitting taxpayers to expense most investments in business assets, regardless of the useful lives of the assets. See OLIVER, *supra* note 4, at 106.

<sup>23</sup> For an influential description and justification of flat tax approaches, see ROBERT E. HALL & ALVIN RABUSHKA, *THE FLAT TAX* (2d ed. 1995). For historical analysis, see Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329 (1996). For an exploration of problems with a flat tax, see Alan L. Feld, *Living with the Flat Tax*, 48 NAT'L TAX J. 603 (1996); Richard A. Musgrave, *Clarifying Tax Reform*, 70 TAX NOTES 731 (1996); David A. Weisbach, *Ironing Out the Flat Tax*, 52 STAN. L. REV. 599 (2000); Lawrence Zelenak, *The Selling of the Flat Tax: The Dubious Link Between Rate and Base*, 2 CHAP. L. REV. 197 (1999).

<sup>24</sup> Not everyone agreed. Objections to the complexity of the modern income tax are almost as old as the tax itself. See, e.g., G.E. Holmes, *Is It Not Time To Simplify the Income Tax?*, BULL. NAT'L TAX ASS'N 11 (1926).

<sup>25</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986).

ing the number of brackets, paring deductions, and substantially eliminating the distinction between capital gains and ordinary income.<sup>26</sup> Alas, the simplification did not long endure. With a few years, brackets increased, deductions and credits multiplied, and the capital gain/ordinary income differential returned. The nearly two decades since 1986 were a bleak era in tax legislation,<sup>27</sup> and the Camelot of 1986 is but memory.

Second, the Alternative Minimum Tax ("AMT") resembles a flat tax, imposing a lower rate (26% to 28%) on a taxable income base considerably broadened through reduced preference items.<sup>28</sup> Yet the AMT, never wholly flat, is becoming less flat as time passes. Increasingly, deductions and credits are being enacted which apply for AMT as well as regular tax purposes.<sup>29</sup> There is much pressure now to modify the AMT further, to minimize the extent to which the AMT hits middle income taxpayers. The contours of the ultimate AMT "fix" are still unclear, but a possible route is allowing more AMT deductions and credits,<sup>30</sup> making the AMT less flat. Similarly, it is unlikely that a flat tax, could it be enacted initially, would remain simple forever, or even for long.

In short, there is a lot of emotional and political "pop" in advocating fundamental tax restructuring, but its fruition probably is just not in the cards. The current situation fortifies me in that conviction. During the Clinton years, many Republicans were vocal supporters of fundamental reform. Now, the Republican Party controls the White House and both houses of Congress, and it succeeded in pushing into enactment two major tax measures and several lesser ones.<sup>31</sup> Yet, neither Republican congressional leadership nor the President have pushed fundamental reform proposals, and the legislation they caused to be enacted tinkers with the income tax instead of replacing it.<sup>32</sup>

If I am correct in the assessment that the income tax is probably here to stay, then our attention should be less on fanciful notions of a new Promised Land of taxation and more on the hard and less glamorous work of improving the land in which we now dwell and will continue to dwell. It is to that task that we now turn.

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<sup>26</sup> For a description of the Act and the process by which it became law, see 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, 23-30 (1990).

<sup>27</sup> See, e.g., Steve R. Johnson, *Further Thoughts on Interpreting Tax Statutes*, 17 ABA SEC. OF TAX'N NEWSL. 11, 12 (no. 4 1998).

<sup>28</sup> See I.R.C. §§ 55-58 (West 2004).

<sup>29</sup> A prominent recent example is the special thirty percent depreciation allowance for property acquired after September 10, 2001 but before September 11, 2004. See I.R.C. § 168(k). That allowance is available for AMT as well as regular income tax purposes. I.R.C. § 168(k)(2)(F).

<sup>30</sup> See, e.g., Leonard E. Burman, William G. Gale, Jeffrey Rohaly & Benjamin H. Harris, *The Individual AMT: Problems and Potential Solutions*, 55 NAT'L TAX J. 555, 584 (2002).

<sup>31</sup> See, e.g., Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752 (2003); Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, 116 Stat. 21 (2002); Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

<sup>32</sup> But see Grover Norquist, *Step-by-Step Tax Reform*, WASH. POST, June 9, 2003, at A21 (prominent conservative tax strategist describes current Republican strategy as an incremental movement in the direction of fundamental tax reform).

## II. NECESSITY OF SIMPLIFICATION

A. *Reasons to Simplify*

I've said that it is important to simplify the federal income tax system. That's not exactly a bold or revolutionary statement. Not many people disagree, at least for public consumption. One rarely hears a person declare "I'm all for complexity. I love the fact that the Internal Revenue Code is mind-numbingly complex!"

It would be naive, though, to overlook the reality that – in fact even if not in profession – some do oppose meaningful simplification because they profit from complexity. As examples: (i) clever taxpayers may think that highly "creative" reporting is harder for the IRS to discover and correct in a complex environment;<sup>33</sup> (ii) the current wave of corporate and high-income individual tax shelters are earning many millions in fees for some tax lawyers, accountants, investment houses, and intermediaries. These shelters typically involve combining sets of tax rules in ways that are novel – often bizarre – and (by Congress) unanticipated. Many of the shelters – thus much of the fees – could not exist absent complexity; (iii) legislators may quietly prefer complexity while loudly decrying it. It is widely believed that it is easier to bury a measure to help an important constituent in a complex set of rules than in a simple set of rules.<sup>34</sup> Moreover, raising PAC money may be easier when the Code is ramshackle and ever-changing than when discipline exists to keep it simple; (iv) the public is easily seduced. Taxpayers loudly complain about complexity, but they are usually quite ready to accept additional tax "goodies" even when their concomitant is yet greater complexity.<sup>35</sup>

While these realities exist, there is overwhelming intellectual consensus (real) and political consensus (partly real, partly lip-service) that our revenue laws require considerable simplification. That being so, we need not argue in ponderous detail the case for simplification. Still, noting a few points will be useful to guide deliberation as to the directions for reform. For me, there are four principal reasons why simplifying the Internal Revenue Code, particularly the federal income tax, is important.

(1) Reduced compliance costs for taxpayers. The more complex the tax system is, the greater the burdens taxpayers bear in complying with it. The compliance burden has been variously estimated. Some of the figures given are almost surely overstated,<sup>36</sup> but widely repeated figures take on lives of their

<sup>33</sup> A prominent recent case-in-point is Enron's tax schemes. See, e.g., Norman A. Kanter, *Joint Committee Looks at How Enron Used Tax Laws To Present an Overly Optimistic Financial Picture*, 21 J. TAX INVESTMENTS 51 (2003); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35; Harold S. Peckron, *Watchdogs that Failed to Bark: Standards of Tax Review After Enron*, 5 FLA. TAX REV. 853 (2002).

<sup>34</sup> This is one of the perceptions behind that staple of tax policy: the "tax expenditures" concept. See, e.g., Stanley S. Surrey & Paul R. McDaniel, *The Tax Expenditure Concept and the Budget Reform Act of 1974*, 17 B.C. INDUS. & COM. L. REV. 679, 697 (1976).

<sup>35</sup> See, e.g., Field, *supra* note 7, at 1125 ("Real simplification has eluded us because we have failed to address head-on the public's addiction to tax incentives . . .").

<sup>36</sup> For instance, one commentator calculated that the total cost of tax compliance in 1985 was over \$360 billion. JAMES L. PAYNE, *COSTLY RETURNS: THE BURDENS OF THE U.S. TAX*

own, irrespective of their accuracy. Still, there is "little doubt that the tax compliance burden is large and wasteful, and that it angers many people from across the political spectrum."<sup>37</sup> Two respected economists have concluded: "The total cost of collecting income taxes, including the value of those billions of hours that taxpayers could have put to better use, probably comes to about \$100 billion per year."<sup>38</sup>

(2) Greater transparency and fairness of the system. The more complex the tax system is, the harder it is to fathom its outcomes. Moreover, different taxpayers have different abilities to manipulate a complex system. There is substantial – and well-founded – public suspicion that well-heeled and well-represented taxpayers can use a complex system to their advantage, while other taxpayers cannot. Such a suspicion can seriously erode voluntary compliance,<sup>39</sup> which is the bedrock of our system.

An aspect of the potential for tax manipulation is of great moment currently. The federal government is now attempting to combat tax shelters marketed to businesses and high-income individuals.<sup>40</sup> The contest is of great revenue importance,<sup>41</sup> and its outcome remains in doubt.<sup>42</sup> Income tax complexity is a main cause and support of current shelters. A complex Code allows shelter promoters to combine sections in ways never intended, anticipated, or

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SYSTEM (1993), *quoted in* WILLIAM W. OLIVER, *WHY WE SHOULD ABOLISH THE INCOME TAX*, 6 (1995). Few others think that figure accurate.

<sup>37</sup> SLEMROD & BAKIJA, *supra* note 10, at 3.

<sup>38</sup> SLEMROD & BAKIJA, *supra* note 10, at 3.

<sup>39</sup> The then-Chief of Staff of the Joint Committee on Taxation remarked that "today's tax complexity . . . clearly decreases levels of voluntary compliance." Lindy L. Paull, *quoted by* Patti Mohr, *Specialists Discuss Simplification in Light of Bush's Tax Plan*, 91 TAX NOTES 867-68 (2001).

The word "voluntary" has sometimes been distorted. The courts have made its meaning clear.

To the extent that income taxes are said to be "voluntary," however, they are only voluntary in that one files the returns and pays the taxes without the IRS first telling each individual the amount due and then forcing payment of that amount. The payment of income taxes is not optional, however, and the average citizen knows that the payment of income taxes is legally required.

*United States v. Schiff*, 876 P.2d 272, 275 (2d Cir. 1989) (citations omitted).

<sup>40</sup> For a discussion of the current wave of tax shelters, see Terril A. Hyde & Glen Arlen Kohl, *The Shelter Problem Is Too Serious Not To Change the Law*, 101 TAX NOTES 119 (2003) (citing numerous sources).

<sup>41</sup> Improper tax shelter schemes have been estimated to cost the Treasury about \$10 billion a year. Stephanie Francis Ward, *IRS Wants Sidley To Name Names: Second Firm Sued for Info on Tax Shelter Clients*, ABA JOURNAL EREPORT (Nov. 7, 2003), available at <http://www.abanet.org/journal/ereport/nov7sidley.html> (last visited June 12, 2004) (on file with the Nevada Law Journal).

<sup>42</sup> Some believe "the government is losing the war on tax shelters." Sheryl Stratton, *KPMG Skewed at Senate Shelter Hearing*, 102 TAX NOTES 942, 944 (2003) (citing Professor Calvin Johnson). On the other hand, testimony recently given to Congress, if true, suggests that tax shelter marketing is declining. Kenneth A. Gary & Sheryl Stratton, *Top Regulators Weigh in on Shelters*, 102 TAX NOTES 947 (2003).



even imagined by Congress. "Complexity becomes the promoter's camouflage."<sup>43</sup>

(3) More accurate tax outcomes. The current system too often is so complex that taxpayers who want to file accurate returns sometimes cannot do so – because they cannot determine with confidence what the law commands of them.<sup>44</sup> In addition, excessive complexity stymies IRS enforcement. When taxpayers file inaccurate returns – either through honest error or through taking aggressive positions – the IRS must be able to detect and correct those inaccuracies. It is no secret that, in important parts, the Internal Revenue Code is now so complex that the IRS cannot enforce it with consistency and rigor.<sup>45</sup>

(4) Improved public support for the tax system. Taxes will never be rip-roaringly popular, of course. Still, it is important that there be broad public support for the system. In the United States, unlike some other countries, taxpayers make the first determination of their liabilities through the returns they prepare and file. Moreover, with the low IRS audit coverage that currently prevails,<sup>46</sup> that first determination usually is the last determination. That being so, it is important that taxpayers have sufficient commitment to the system that their returns bear reasonable relation to reality. A very complex system that alienates taxpayers undercuts the base of support crucial to the enterprise of American taxation.<sup>47</sup>

### B. Types of Simplification

To say that the complexity of federal taxes has reached undesirable levels is too broad. The phenomenon of complexity is itself complex. Tax complexity takes a variety of at least partially distinguishable forms. Consider three of them:<sup>48</sup>

<sup>43</sup> Mark Everson (IRS Commissioner), *quoted by* Gary & Stratton, *supra* note 42, at 947 (identifying Code complexity as one of four factors contributing to the proliferation of abusive shelters).

<sup>44</sup> See, e.g., MICHAEL C. DURST (reporter), REPORT OF THE SECOND INVITATIONAL CONFERENCE ON INCOME TAX COMPLIANCE 49 (1988).

<sup>45</sup> See, e.g., *id.* at 10 (some provisions of the Code "are so complex as to be virtually unadministrable").

<sup>46</sup> The "official" audit rate is now around one-half of one percent of all returns filed. IRS 2002 DATA BOOK 17, tbl.10, col.3. This is down from about 4.5 to 5% in the mid-1960s. Sheldon S. Cohen, *The Erwin N. Griswold Lecture*, 14 AM. J. TAX POL'Y 113, 117 (1997). These statistics both understate and overstate true coverage, but the impression of low enforcement surely is correct. See Johnson, *supra* note 9, at 1015-21.

Claims have been made recently that IRS enforcement is moving back upwards, but these claims have been disputed. See Jonathan Weisman, *IRS Tax Enforcement Still Sliding*, Washingtonpost.com (Apr. 12, 2004), at <http://www.washingtonpost.com/wp-dyn/articles/A4247-2004Apr11.html> (last visited June 12, 2004).

<sup>47</sup> See, e.g., Field, *supra* note 7, at 1125 ("the baroque complexity of our tax system – especially the income tax – drives ordinary taxpayers to distraction, saps their confidence in the rationality or fairness of the system, and lessens their willingness to bear the tax burdens it imposes").

<sup>48</sup> For further discussion, see WILLIAM D. POPKIN, FUNDAMENTALS OF FEDERAL INCOME TAX LAW 32-33 (4th ed. 2002). For a slightly different taxonomy of complexity, see Charles E. McLure, Jr., *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25, 41-43 (1989).

(1) Detail complexity. This exists when one can reach the right result, can figure out the result the law requires, but there are so many rules to wade through that it is exhausting to reach that right result.

(2) Outcome complexity. This exists when the law is not clear about the result it commands, i.e., when different people reading the rules can reach different conclusions. At the least, this phenomenon breeds controversy and litigation, expending scarce resources. At the worst, it leads to unpredictable and irreconcilable administrative and judicial decisions.

(3) Forms complexity. This is the variety of which most people complain. The complaint is that there is just too much paper that taxpayers have to generate, file, and retain.

As a result of these multiple aspects, simplification sometimes involves trade-offs. A measure that reduces one aspect of complexity may increase another aspect. We will explore such trade-offs in the proposals in Part V. For now, let us note only that useful simplification may entail alleviation of one or more of detail, outcome, or forms complexity.

### III. SIMPLIFICATION AND ADMINISTRABILITY

When I teach the introductory Federal Income Tax course, I often begin by asking the students to identify the goals that a tax system should serve, criteria by which the success or failure of the system should be measured. Students adduce some goals and criteria with alacrity, such as revenue raising, fairness in burden distribution, economic efficiency and incentives, political acceptability, and furthering social policy.

Eventually, usually late in the discussion, a student will identify another goal: administrability – the ability of taxpayers, the IRS, and the courts to apply the Code with reasonable accuracy and without unreasonable expense. The after-thought quality of the entrance of administrability into the class reflects an all-too-often after-thought treatment of administrability by Congress and the Treasury.

To be sure, there are many tax statutes and regulations that were prompted by administrability considerations. However, the principle is honored more in the breach than in the observance. I believe that the principle merits greater emphasis. In particular, substantial emphasis on administrability is important to effective tax simplification.

In crafting legislation and regulations, a choice often must be made. The measure will exist to advance a purpose or, more likely, purposes since each rule reflects a stopping point as well as a direction – the stopping point reflecting compromise between or among different values.<sup>49</sup> Difficult trade-offs are routine in tax legislation. As the Treasury recently observed:

The goal of tax policy is to raise revenue in an equitable, efficient, and simple manner. These goals often are in conflict. A tax system that is perceived as equitable may be complicated, while a system that is simple may be unfair or inefficient. Simplification and other policy goals may also be sacrificed when the tax system is used

<sup>49</sup> See Frank H. Easterbrook, *Statutes' Domains*, 50 U. CHI. L. REV. 533, 540-44 (1983).

to achieve additional economic and social policy goals, such as encouraging home ownership or work.<sup>50</sup>

Although perfection is beyond our grasp,<sup>51</sup> how do we reach the least flawed outcome?

Often, the choice is between two ways to proceed: first, write a very complex statute or regulation that, at least in theory, serves the purpose(s) with great precision, or second, write a statute or regulation that, at least in theory, achieves a bit less of the purpose(s) but is far clearer, less complex, and easier to administer.<sup>52</sup>

I think the better choice almost always is the latter: the less theoretically exact but more administrable alternative. Too often, though, Congress and/or the Treasury have chosen the other path.<sup>53</sup> A problem with that choice is that almost no one outside the Washington Beltway thinks that intricate rules are applied on the ground the way that Congress and/or the Treasury hope or expect them to be. Taxpayers ignore rules they can't understand, and the IRS lacks the ability to rein in such departures. The call of reality is to accept this fact from the beginning, thus to raise the status of administrability relative to theoretical precision.

In urging this reorientation, I am not attempting to either increase or decrease the revenue stream flowing into federal coffers. My goal, simply, is a tax system that works. Sometimes, practicability and administrability will mean moving a rule actually or apparently in a pro-taxpayer direction. Other times, they will mean moving it in an actually or apparently pro-revenue direction.

Another way to put the matter is to say that Congress must either simplify the tax laws or must significantly increase IRS budgets. Perhaps complex revenue laws can be applied – but only if the IRS gets big budget increases to fund taxpayer education and service on the one hand and much more vigorous enforcement on the other hand.<sup>54</sup> The President and Congress routinely underfund the IRS, as they do many other administrative agencies. They can alter this practice and pour billions more each year into the IRS to apply and

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<sup>50</sup> U.S. DEP'T OF TREAS., RETURN-FREE TAX SYSTEMS: TAX SIMPLIFICATION IS A PREREQUISITE 1 (Dec. 2003).

<sup>51</sup> "Whoever hopes a faultless tax to see, hopes what ne'er was, is not, and ne'er shall be." Alexander Pope, *quoted by* Jeffrey L. Yablon, *As Certain as Death-Quotations About Taxes (Expanded 2002 Edition)*, 96 TAX NOTES 395, 397 (2002).

<sup>52</sup> For simplicity, I have phrased the choice as binary. Of course, there often will be multiple possibilities, or different points on a spectrum between the two conceptual poles.

<sup>53</sup> A provision in the massive 1998 IRS restructuring legislation reflects this realization. That legislation includes a "sense of the Congress" provision that, during the tax legislative process, frontline IRS technical experts henceforth should give the House and Senate tax-writing committees their views as to the administrability of proposed changes to the Code. Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 4021, 112 Stat. 685, 785 (1998). In addition, the Act requires annual and other tax law complexity analyses. *Id.* § 4022, 112 Stat. at 785-87.

<sup>54</sup> For a discussion of these activities and the need to better fund them, see Johnson, *supra* note 9, at 1027-39. For an update on IRS funding prospects, see George Guttman, *IRS Budget Request for 2005 Previewed*, 101 TAX NOTES 997 (2003).

enforce the Code as it stands, or they can continue current underfunding practice and simplify the Code.<sup>55</sup>

#### IV. PRECEDENTS

Administrability-based tax simplification opportunities fall into two broad categories. First, some regimes now in the tax law are not worth saving in any form. As to them, the game just is not worth the candle. The appropriate simplification would be to abolish them outright.<sup>56</sup> Second, there are other aspects of the law that should not be wholly eliminated but which can be profitably streamlined. In these areas, I advocate advancing simplification through more mechanical approaches; that is, doing rough justice with reasonable certainty, instead of pursuing decimal-point precision with little realistic expectation of achieving it.

Some significant and successful features of the current Code reflect administrability-based simplification. I list several of these precedents below. I will not try to be comprehensive. Instead, my purpose is to illustrate that administrability-based simplification has some pedigree in American taxation. Consider three instances: Code Sections 63(c), 102(c), and 152(e).

##### A. Section 63(c)

The Code has long allowed taxpayers to take deductions against income. Scores of deduction sections are now in the Code. Each deduction was enacted for a particular purpose. Some help to define the taxpayer's income<sup>57</sup> or measure her ability to pay.<sup>58</sup> Others reflect non-revenue purposes, such as economic or social engineering.<sup>59</sup> Theoretical perfection would require that each tax return specifically claim each deduction for which the taxpayer qualifies for the year and in the amount for which he qualifies.

But, for reasons of simplicity, we do not require that of individual taxpayers. Since 1944, a standard deduction (currently in I.R.C. § 63(c)) has been available to individuals as an alternative to itemized deductions. For tax year 2003, the standard deduction (for unmarried taxpayers or married taxpayers

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<sup>55</sup> The alternative to those two possibilities is unacceptable: continued erosion of compliance with our revenue laws. See Johnson, *supra* note 9, at 1031-39.

<sup>56</sup> Here's an example. The United States currently levies three major wealth transfer taxes: the estate, gift, and generation-skipping transfer taxes. I, and a number of others, would abolish all three of these taxes as well as I.R.C. § 102, the provision that excludes gifts and inheritances from the reach of the income tax. Thus, wealth transfers still would be taxed, but in a fashion more consistent with our conceptualization of income and – crucially – greatly simplifying the federal tax structure. See, e.g., Joseph M. Dodge, *Beyond Estate and Gift Tax Reform: Including Gifts and Bequests in Income*, 91 HARV. L. REV. 1177 (1978); Marjorie E. Kornhauser, *The Constitutional Meaning of Income and the Income Taxation of Gifts*, 25 CONN. L. REV. 1 (1992); John K. McNulty, *A Transfer Tax Alternative: Inclusion Under the Income Tax*, 4 TAX NOTES 24 (1976).

<sup>57</sup> E.g., I.R.C. § 162 (West 2004) (allowing deduction of ordinary and necessary business expenses).

<sup>58</sup> E.g., I.R.C. § 213 (allowing deduction of some medical expenses).

<sup>59</sup> 9 E.g., I.R.C. §§ 163(a), (h)(2)(A), 170 (allowing deduction of, respectively, some home mortgage interest expenses and charitable contributions).

filing separate returns) was \$4750.<sup>60</sup> A taxpayer tabulates her itemized deductions on Schedule A of the income tax return. If their total exceeds \$4750, the taxpayer will claim the itemized deductions. If their total is less than \$4750, the taxpayer will eschew itemization, claiming the \$4750 standard deduction instead.

Since the inception of the standard deduction and still today, the clear majority of taxpayers have used the standard deduction.<sup>61</sup> But this entails several aspects of imprecision. (1) Taxpayers who claim the standard deduction because its amount exceeds their itemized deductions have received excessive allowances, to the detriment of the fisc. (2) Some taxpayers whose itemized deductions exceed the standard deduction amount still use the standard deduction. It is easier, and it obviates the need to obtain and preserve substantiating documents. These taxpayers have been over-taxed, albeit by their own choice. (3) Consider a taxpayer whose itemized deductions are below the standard deduction threshold and who is considering spending money on something qualifying for itemized deduction (making a charitable contribution, for example). That taxpayer would realize that he would get little or no tax benefit for the expenditure since the additional itemized deduction would simply replace otherwise allowable standard deduction. This fact can blunt incentives Congress was trying to create in enacting itemized deductions. In other words,

[t]he standard deduction reduces the value of itemized deductions. Regardless of whether a taxpayer has no actual itemized deduction or actual itemized deductions exactly equal to the standard deduction, his taxable income is the same. The standard deduction can be viewed therefore as disallowing an equivalent amount of itemized deductions or as giving a free ride to taxpayers who have not incurred any expenses generating itemized deductions. Whether the itemized deductions are viewed as helping to define the taxpayer's economic income . . . , as incentives to engage in socially useful conduct . . . , or as tailoring tax liabilities to the taxpayer's ability to pay . . . , the standard deduction interferes with the achievement of these objectives.<sup>62</sup>

These effects notwithstanding, Congress acted well in creating the standard deduction. That device is among the most important and successful instances of administrability-based simplification in the income tax. It promotes all three types of simplification identified earlier.<sup>63</sup> It decreases detail complexity since non-itemizing taxpayers can ignore scores of Code sections. It reduces forms complexity since Schedule A and supporting schedules, forms, and worksheets can be omitted. It eases outcome complexity since the amount of the available deduction is known with certainty. Controversy rarely arises when the standard deduction has been claimed.<sup>64</sup>

<sup>60</sup> The standard deduction is adjusted annually for cost-of-living changes. I.R.C. § 63(c)(4).

<sup>61</sup> Originally, over eighty percent of taxpayers used the standard deduction. BORIS I. BITTKER, MARTIN J. McMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 21.4[1] - ¶ 21.4[2] (3d ed. 2002). Now, about two-thirds do. See Internal Revenue Service, Tax Stats at a Glance (Oct. 17, 2003), available at <http://www.irs.gov/taxstats/article/0,,id=102886,00.html> (last visited June 12, 2004).

<sup>62</sup> BITTKER, McMAHON & ZELENAK, *supra* note 61, at ¶ 21.4[2].

<sup>63</sup> See *supra* text accompanying note 48.

<sup>64</sup> The amount of the standard deduction depends on the taxpayer's filing status (see I.R.C. § 63(c)(2), (g) (West 2004)), which is occasionally controversial. Taxpayers occasionally

The simplification gains produced by the standard deduction easily preponderate over the mechanism's ill effects. Indeed, Congress has underscored the importance it attaches to the standard deduction. On several occasions, as taxpayer use of the standard deduction flagged, Congress changed the statute to increase the attractiveness, and so the use, of the standard deduction.<sup>65</sup>

### B. Section 102(c)

Under the modern federal income tax, donees typically need not pay tax on gifts they receive.<sup>66</sup> Whether a given transfer constitutes a gift for this purpose depends on the state of mind of the transferor. "[I]f the payment proceeds primarily from the constraining force of any moral or legal duty or from the incentive of anticipated benefit of an economic nature, it is not a gift."<sup>67</sup> The transfer is an excludible gift only if it proceeds from "detached and disinterested generosity" on the part of the transferor, "out of affection, respect, admiration, charity or like impulses."<sup>68</sup>

The statute identifies several types of transfers that do not qualify for the exclusion. As relevant here, I.R.C. § 102(c) provides that the exclusion does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee."<sup>69</sup> This rule is a categorical disqualification from the exclusion, not a mere presumption. That is, employer-to-employee transfers never can be excluded from taxability – even if it is conclusively established that the employer made the transfer out of detached and disinterested generosity.

Thus, by the measuring stick of the "detached and disinterested generosity" standard, Section 102(c) prevents perfect justice. Each year, there will be some cases in which such generosity *was* the primary cause of an employer's transfer to an employee. They will be rare (employers more often part with money in order to reward past employee efforts or to motivate future employee efforts), but they will occur.<sup>70</sup> Employers like Mr. Fezziwig<sup>71</sup> are not the norm, but they do exist. Section 102(c) bars the door of exclusion to employee-donees of such employer-donors. Each time this happens is an imprecision in light of the standard defining excludible gifts.

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rule their standard versus itemized choice and try to change it, provoking controversy. See I.R.C. § 63(e)(3). The standard deduction is increased for aged and blind taxpayers. See I.R.C. § 63(f). This occasionally involves classification controversy. But these are about the only conflicts, and disputes on such grounds are not particularly common.

<sup>65</sup> See BITTKER, McMAHON & ZELENAK, *supra* note 61, ¶ 21.4[2].

<sup>66</sup> I.R.C. § 102(a); see generally Douglas A. Kahn & Jeffrey H. Kahn, "Gifts, Gifts, and Gifts" – the Income Tax Definition and Treatment of Private and Charitable "Gifts" and a Principled Policy Justification for the Exclusion of Gifts from Income, 78 NOTRE DAME L. REV. 441 (2003). Gifts were taxable under some prior versions of the federal income tax. E.g., Tariff Act of 1894, ch. 349, § 28, 28 Stat. 553 (1894).

<sup>67</sup> *Comm'r v. Duberstein*, 363 U.S. 278, 285 (1960) (internal quote marks and citations omitted).

<sup>68</sup> *Id.* (internal quote marks and citations omitted).

<sup>69</sup> I.R.C. § 102(c)(1) (added to I.R.C. by Pub. L. No. 99-514 in 1986).

<sup>70</sup> For a discussion of the problematic "mixed motive" cases, see BITTKER, McMAHON & ZELENAK, *supra* note 61, ¶ 5.2[3] - ¶ 5.2[7].

<sup>71</sup> The kindly first employer of the young Ebenezer Scrooge in Dickens' A CHRISTMAS CAROL.

Nonetheless, Congress was right to enact Section 102(c). Without the provision, many employees would claim the exclusion as to payments from their employers. The general standard is subjective,<sup>72</sup> and eager, tax-minimizing taxpayers often wear rose-colored glasses. Though some of the claimed exclusions would be valid under the standard, the great majority would not be. Given low IRS audit rates,<sup>73</sup> many of the invalid claims would never be challenged by the IRS. Of the claims that the IRS did disallow, and that were litigated, taxpayers would prevail in some cases but would lose in far more.

The costs – in money, time, and stress – of controversy resolution are high, both to the parties and to the system. Given that, it is a reasonable, indeed wise, decision to screen out this whole class of possible exclusion claims. The costs of sifting through many meritless cases to discover a few meritorious cases are not worth incurring. Section 102(c) exemplifies administrability-based simplification, a rational choice for rough-justice simplicity over theoretically more precise complication.

And, again, the rule more precise in theory may not be so in fact. Litigation outcomes are inherently uncertain, particularly when the litigation proceeds under a subjective standard.<sup>74</sup> Cases sometimes turn on adventitious matters. So, were Section 102(c) not in the law, not all contested cases would be decided correctly under the “detached and disinterested generosity” standard. Some good claims would fail; some bad claims would succeed. This inevitability further underscores the wisdom of the administrability-based Section 102(c).

### C. Section 152(e)

Taxpayers may take income tax deductions for personal exemptions for dependents.<sup>75</sup> Several tests must be satisfied for a taxpayer to claim another as a dependent. One is that the taxpayer must have provided over half of the support for the putative dependent during the tax year in question.<sup>76</sup> Under Section 152(e), a special rule applies for a child of divorced or legally separated parents. In general, the parent having custody of the child for the greater portion of the year “shall be treated” as having provided over half of the sup-

<sup>72</sup> See, e.g., Burgess J.W. Raby & William L. Raby, *Tax Status of Gifts That May Be Compensatory*, 100 TAX NOTES 925, 927-28 (2003) (concluding that the *Duberstein* standard “is highly subjective. For that reason, taxpayers have fairly wide latitude in classifying as gifts amounts they receive.”).

<sup>73</sup> See *supra* text accompanying note 46.

<sup>74</sup> For example, *Stanton v. United States*, a companion case to the seminal *Commissioner v. Duberstein* case, involved a taxpayer who had been employed by a corporation for ten years. When he retired, the company paid him \$20,000. The company called the payments a “gift.” There was conflicting evidence as to whether the payment was made because the taxpayer was well-liked personally or because of his work on the company’s behalf. The IRS determined that the payments were not gifts; the district court held that they were; the Second Circuit reversed, holding for the IRS; and the Supreme Court (with four justices dissenting) vacated and remanded the case to the district court. *Stanton v. United States*, 363 U.S. 278, 281-83, 292-93 (1960).

<sup>75</sup> I.R.C. § 151(a), (c) (West 2004). Dependency status matters for several other purposes as well. See, e.g., I.R.C. § 21(a), (b)(1)(A) (credit for costs of care services rendered to § 151 dependent, if the services are necessary for gainful employment).

<sup>76</sup> I.R.C. § 152(a).

port for the child,<sup>77</sup> and is thus the parent who can claim the child as a dependent.

In some instances, this special rule will lead to theoretical imprecision. The non-custodial (or lesser custodial) parent sometimes provides over half the support for the child.<sup>78</sup> As was true of Section 102(c) discussed above, Section 152(e) is an absolute rule, not a mere presumption.<sup>79</sup> The custodial parent will be allowed the dependency exemption even if the non-custodial parent proves that she (not the custodial parent) provided the bulk of the support.<sup>80</sup> Since the dependency exemption is intended to cushion the economic strains (not the other strains) of child-rearing, the special rule yields imprecise results in such cases, at least in theory.

Nonetheless, Section 152(e) makes a lot of sense for the two reasons we've noted before. First, theoretical precision does not guarantee precision in actual operation. When the parents are not cooperative (a situation not unheard of in cases of divorce or separation) and when only one of the parents is before the IRS or the court, it can be "exceedingly difficult, if not impossible" to determine precisely how much each parent contributed to the support of the child.<sup>81</sup>

Second, and more important, any loss of precision as a result of Section 152(e) is amply compensated for by the huge gain in administrability the provision accomplishes. The long time chair of the House Ways and Means Committee explained the need for Section 152(e) thusly:

The number of disputes involving this issue is so great that it has cast a serious administrative burden on the Service and has tended to clog the administrative machinery involved in bringing them to a conclusion. In fact, a disproportionate number of these cases are taken to the Tax Court for resolution. It has been estimated by the Service that during a recent year 5 percent of all income tax cases handled at the informal conference level of the administrative process involved this issue as the principal issue. The amounts involved in these cases, although significant to the taxpayers, are quite small. The costs to the taxpayers and the Government of resolving this issue in the administrative process and in the Tax Court are inordinate when compared with the amounts involved.<sup>82</sup>

With the growing number of divorces since adoption of Section 152(e) in 1967, the need for the provision is even greater now. Section 152(e) is a clear example of condign administrability-based tax simplification.

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<sup>77</sup> I.R.C. § 152(e)(1) (added to the Code by Pub. L. No. 90-78 in 1967).

<sup>78</sup> "Support" for this purpose is measured exclusively monetarily. Love, care, labor, and services do not figure into the support calculation. *E.g.*, *Bartsch v. Comm'r*, 41 T.C. 883 (1964) (en banc).

<sup>79</sup> There are some statutory and case law exceptions to the rule of I.R.C. § 152(e)(1). *E.g.*, I.R.C. § 152(e)(2) (written agreement shifting the exemption to non-custodial spouse); *Prophit v. Comm'r*, 57 T.C. 507 (1972) (en banc), *aff'd*, 470 F.2d 1370 (5th Cir. 1973) (United States non-custodial parent allowed the exemption when the custodial parent is not a United States citizen or resident and does not file United States income tax returns). Absent some special circumstance, however, Section 152(e)(1) is absolute.

<sup>80</sup> *E.g.*, Treas. Reg. § 1.152-4(f) ex.(1) (2002).

<sup>81</sup> *Labay v. Comm'r*, 55 T.C. 6, 9 (1970), *aff'd*, 450 F.2d 280 (5th Cir. 1971).

<sup>82</sup> H. REP. NO. 102, 90th Cong., 1st Sess. 3 (1967); S. REP. NO. 488, 90th Cong., 1st Sess. 2-3 (1967); 113 Cong. Rec. 6611 (1967) (remarks of Rep. Wilbur Mills).



## V. PROPOSALS

As far as candidates for simplification go, the Internal Revenue Code is a target-rich environment. Scores, indeed hundreds, of portions of the Code are ripe for administrability-based simplification. Some such changes already have been proposed. For instance, I think highly of many of the possibilities identified by the Joint Committee<sup>83</sup> and by the National Taxpayer Advocate.<sup>84</sup>

However meritorious, these suggestions do not exhaust the field of possibilities. On a prior occasion, I described a number of simplification possibilities as to procedural mechanisms established or enhanced by the 1998 IRS restructuring legislation.<sup>85</sup> Now, I offer three other proposals, all in the area of income taxation of business entities and their owners.<sup>86</sup> The proposals are: (1) decrease pass-through regimes from two to one, (2) abolish the TEFRA partnership audit rules, (3) and eliminate the accumulated earnings tax.

*A. Decrease the Number of Pass-Through Regimes**1. Complexity*

Currently, there are three principal income tax regimes for business entities.<sup>87</sup> C corporations are viewed as separate from their shareholders and so are independent taxable entities.<sup>88</sup> In contrast, some entities are treated as pass-through vehicles. For the most part, these entities do not themselves pay federal income tax. The tax results of their operations flow through to their owners and are reported on the owners' income tax returns. The two main pass-through regimes are partnerships under Subchapter K<sup>89</sup> and S corporations under Subchapter S.<sup>90</sup>

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<sup>83</sup> STAFF OF JOINT COMM. ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986 (2001).

<sup>84</sup> See National Taxpayer Advocate, FY 2002 Annual Report to Congress 156-247; National Taxpayer Advocate, FY 2001 Annual Report to Congress 72-227. Not all of the changes suggested in these reports are simplifications. Many are.

<sup>85</sup> See Johnson, *supra* note 9, at 1054-62.

<sup>86</sup> For proposals reconceptualizing taxation of business income and enterprises, see Armando Gomez, *Rationalizing the Taxation of Business Entities*, 49 TAX LAW. 285 (1996); Jeffrey L. Kwall, *Taxing Private Enterprise in the New Millennium*, 51 TAX LAW. 229 (1998).

<sup>87</sup> Additional regimes exist for various specialized entities, including banks, I.R.C. §§ 581-97 (West 2004); electing large partnerships, I.R.C. §§ 771-77; life insurance companies, I.R.C. §§ 801-18; other insurance companies, I.R.C. §§ 831-35; regulated investment companies, I.R.C. §§ 851-855; real estate investment trusts, I.R.C. §§ 856-59; real estate mortgage investment conduits, I.R.C. §§ 860A-860G; financial asset securitization investment trusts, I.R.C. §§ 860H-860L; and cooperatives, I.R.C. §§ 1381-88.

<sup>88</sup> I.R.C. § 11(a); see also I.R.C. §§ 301-85.

<sup>89</sup> I.R.C. §§ 701-77.

<sup>90</sup> I.R.C. §§ 1361-78.

The rules for the two pass-through regimes are similar in some ways<sup>91</sup> but differ in other ways.<sup>92</sup> Although there are peculiarities under Subchapter S, on the whole Subchapter K involves greater complexity.<sup>93</sup> There is irony here since simplicity was a purported goal of Subchapter K. In enacting the partnership tax rules, Congress sought “simplicity, flexibility, and equity as between partners.”<sup>94</sup> Yet – as often is the case – flexibility, equity, and other goals (such as abuse prevention) eclipsed the simplicity goal.

The Subchapter K rules are tolerable for simple partnerships, such as those that have no special allocations, that have assets of only a few, relatively homogenous kinds, and that eschew various elections available to them under Subchapter K.<sup>95</sup> However, as a partnership’s contributions, distributions, allocations, or other operations become more varied, Subchapter K becomes mind-numbingly complex in important respects. Consider a few illustrations of this complexity:

(i) Rules governing the allocation among the partners of the partnership’s items of income, deductions, credits, and basis: A striking instance is the *Interhotel* case, where the IRS maintained that the partnership’s allocations were invalid under the governing regulations.<sup>96</sup> In the first opinion in the case, the Tax Court accepted the IRS’s position.<sup>97</sup> On appeal, however, the Government conceded that “it erred in convincing the Tax Court to refrain from including a minimum gain chargeback in the court’s calculations for purposes of the comparative liquidation test” set out in the regulations.<sup>98</sup> Accordingly, the circuit court vacated and remanded. When the IRS and the Tax Court stroll together down the path of later admitted error, one may suspect that there is

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<sup>91</sup> For instance, in both regimes, basis is the mechanism used to track investment in the entity and ultimately to insure that the business’ profits are taxed only once. Many items produce similar basis adjustments under both Subchapter K and Subchapter S. Compare I.R.C. §§ 705 & 752 to I.R.C. § 1367.

<sup>92</sup> For example, entity-level borrowing increases partners’ bases but does not increase S shareholders’ bases, a significant trap for the unwary. See, e.g., 1 BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 6-32 to 6-33 (7th ed. 2002).

<sup>93</sup> For a comparison of principal aspects of partnership and S corporation taxation, see John W. Lee, *Choice of Small Business Tax Entity: Facts and Fictions*, 87 TAX NOTES 417, 431-32 (2000); Richard W. Mertens, *Choosing Between a Limited Liability Company and an S Corporation*, N.Y.S. BAR J., May/June 1996, at 52; Walter D. Schwidetzky, *Is It Time To Give the S Corporation a Proper Burial?*, 15 VA. TAX REV. 591, 596-611 (1996).

<sup>94</sup> H. REP. NO. 83-1337, at 66 (1954); S. REP. NO. 83-1622, at 101 (1954).

<sup>95</sup> Another example is the election under I.R.C. § 754 (2002), which leads to complex basis readjustments under such sections as 734(b) and 755 (2002). For a discussion of such elections and their consequences, see LAURA E. CUNNINGHAM & NOEL B. CUNNINGHAM, *THE LOGIC OF SUBCHAPTER K: A CONCEPTUAL GUIDE TO THE TAXATION OF PARTNERSHIPS* ch. 12 (2d ed. 2000).

<sup>96</sup> Treas. Reg. § 1.704-1(b) (2002).

<sup>97</sup> *Interhotel Co. v. Comm’r*, 74 T.C.M. (CCH) 819 (1997).

<sup>98</sup> *Interhotel Co. v. Comm’r*, 221 F.3d 1348, 2000 WL 674745, \*1 (9th Cir. 2000) (per curiam; unpublished disposition). On remand, the Tax Court again held for the IRS but this time on a better rationale. *Interhotel Co. v. Comm’r*, 81 T.C.M. (CCH) 1804 (2001).

some outcome complexity about the rule at issue. Yet this is not the first time such a walk has been taken in partnership tax litigation.<sup>99</sup>

(ii) Rules characterizing transactions between partners and their partnership: When a partner sells property to a partnership in which she is a partner, loans money to it, or conducts other business with it, how should those dealings be categorized? Depending on several factors, the Code gives any of three answers: an entity approach, an aggregate approach, and a hybrid approach.<sup>100</sup> The result is that this is “[o]ne of the more difficult issues under Subchapter K . . . both conceptual[ly] and practical[ly].”<sup>101</sup> For instance, Congress has changed its mind about such characterizations over time.<sup>102</sup> In 1981, the IRS reversed its view of a 1975 Tax Court victory it had won in the area.<sup>103</sup>

(iii) Rules governing liquidating payments to a retired partner or the estate of a deceased partner. The applicable statute, I.R.C. § 736, is a poster-child for awkward drafting. This arises from the fact that the statute was revised at various times by Congresses whose goals and preferences differed as to how to treat such payments. The exasperation of dealing with the section was captured in this “cry from the judicial heart” by the Tax Court:

The distressingly complex and confusing nature of the provisions of Subchapter K present a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. . . . If there should be any lingering doubt on this matter one has only to reread section 736 in its entirety . . . and give an honest answer to the question whether it is reasonably comprehensible to the average lawyer or even to the average tax expert who has not given special attention and extended study to the tax problems of partners. Surely, a statute has not achieved “simplicity” when its complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.<sup>104</sup>

Of the varieties of complexity identified previously,<sup>105</sup> detail complexity<sup>106</sup> and forms complexity<sup>107</sup> appear in Subchapter K, but they are dwarfed by outcome complexity. In part, this results from ambiguities particular to

<sup>99</sup> See *Campbell v. Comm’r*, 943 F.2d 815, 818 (8th Cir. 1991), *rev’g* 59 T.C.M. (CCH) 236 (1990) (Government, at appeal, conceded error as to the Tax Court decision for the IRS that receipt of a partnership profits interest in return for services rendered to the partnership gave rise to immediate inclusion into income for the service-rendering partner).

<sup>100</sup> I.R.C. §707(a), (c) (West 2004); see, e.g., GLENN E. COVEN, ROBERT J. PERONI & RICHARD CRAWFORD PUGH, *TAXATION OF BUSINESS ENTERPRISES* ch. 20 (2d ed. 2002).

<sup>101</sup> COVEN, PERONI & PUGH, *supra* note 100, at 968.

<sup>102</sup> See *id.* at 968-69 & n.1.

<sup>103</sup> Rev. Rul. 81-300, 1981-2 C.B. 143, 144 (commenting on *Pratt v. Comm’r*, 64 T.C. 203 (1975), *aff’d in part & rev’d in part*, 550 F.2d 1023 (5th Cir. 1977)).

<sup>104</sup> *Foxman v. Comm’r*, 41 T.C. 535, 551 n.9 (1964), *aff’d*, 352 F.2d 466 (3d Cir. 1965).

<sup>105</sup> See *supra* text accompanying note 48.

<sup>106</sup> The impenetrable substantial economic effect regulations, Treas. Reg. § 1.704-1 (2002), are the clearest example, though other partnership tax regulations also stake impressive claims to being unreadable.

<sup>107</sup> Schedules K and K-1 of Form 1065, the partnership return, require more work than really needed to promote important tax administration objectives. They could and should be streamlined. See CUNNINGHAM & CUNNINGHAM, *supra* note 95, at 26-27.

given sections, such as Section 736 just discussed.<sup>108</sup> In other part, it results from Congress' failure to select and rigorously implement a coherent conceptualization of partnerships. Specifically, sometimes Subchapter K treats partnerships as mere aggregates of their owners; other times, Subchapter K treats partnerships as entities separate from their owners; Subchapter K sometimes takes a hybrid approach, treating partnerships partly as aggregates and partly as separate entities; and yet at other times, aggregate versus entity treatment is elective for partnerships and their owners.<sup>109</sup>

This schizophrenia reflects a tendency we noted earlier: the pursuit of theoretical precision even at the price of great complication. Sometimes, the desired precision is ostensibly to benefit the fisc – to foreclose avenues of potential abuse. Other times, it is for the ostensible benefit of taxpayers. In both dimensions, though, a rough justice alternative often would yield tolerable outcomes with far less complexity. Consider the following two examples involving purchase and sale of partnership interests.

(i) When a taxpayer sells a partnership interest, how should the resultant gain or loss be treated? Entity theory would treat the sale as unitary: the taxpayer sold one asset, the partnership interest. This would make the gain or loss capital in nature.<sup>110</sup> In contrast, aggregate theory would treat the sale as multiple in nature: sale of the partnership interest is sale of an undivided interest in each of the partnership's assets. Thus, the gain or loss on sale may be part capital and part ordinary depending on whether the partnership's assets are capital or ordinary in character.

Subchapter K takes a hybrid approach. The general rule is entity in nature, capital gain or loss.<sup>111</sup> However, a subsequent section partly overrides that general rule. It treats the gain or loss as ordinary to the extent it comes from certain ordinary income assets of the partnership.<sup>112</sup> In theory, this protects the Government, preventing the abuse or imprecision of allowing capital gain treatment even on the portion of gain which ultimately is attributable to ordinary assets.<sup>113</sup>

But, of course, the part entity/part aggregate approach taken by Subchapter K comes at a cost: considerably increased complexity as compared to a pure entity approach.<sup>114</sup> Is the benefit worth the cost? I doubt it. When C corpora-

<sup>108</sup> For another example, see Stephen Utz, *Allocation and Reallocation in Accordance with the Partners' Interests in the Partnership*, 56 TAX LAW. 357 (2003) (discussing outcome complexity as to Treas. Reg. § 1.704-1(b)(3) & (4)).

<sup>109</sup> See, e.g., WILLIAM F. MCKEE, WILLIAM F. NELSON & ROBERT L. WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* 1-6 to 1-9 (3d ed. 1997).

<sup>110</sup> The partnership interest would be a capital asset under I.R.C. § 1221 (West 2004), and the sale of a capital asset produces capital gain or loss under I.R.C. § 1222.

<sup>111</sup> I.R.C. § 741.

<sup>112</sup> I.R.C. § 751(a) (dealing with unrealized receivables and inventory items of the partnership).

<sup>113</sup> Of course, the gate swings both ways. Changing capital losses into ordinary losses depresses federal revenues, just as changing capital gains into ordinary gains enhances revenues.

<sup>114</sup> I.R.C. § 751, the so called "collapsible partnership" rules, is best by "fearsome complexities," MCKEE, NELSON & WHITMIRE, *supra* note 109, at 16-7, and, in the opinion of some, is "the most complex part of Subchapter K," AMERICAN LAW INSTITUTE, *FEDERAL INCOME TAX PROJECT: SUBCHAPTER K: PROPOSALS ON THE TAXATION OF PARTNERS* 8 (1984). In

tion stock is sold, the Code uses an unalloyed entity (capital) approach. The same is true when S corporation stock is sold.<sup>115</sup> Far more capital and tax revenue is at stake as to sales of C and S corporation stock than as to sales of partnership interests. If the nation can bear without undue pain the “imprecision” of an entity approach in the larger context, it should be able to do so in the smaller context. Contrary to Subchapter K, I would make the choice for rough justice simplicity over complex theoretical precision, even if that entails surrendering some revenue in partnership-interest sale cases.

(ii) An ostensibly pro-taxpayer complication involves outside basis/inside basis adjustments.<sup>116</sup> Assume a new partner (“Nate”) buys a partnership interest from a prior partner. Nate’s basis in that partnership interest (so called “outside basis”) will be the sum of what he paid for the interest plus the share of partnership liabilities allocable to that interest.<sup>117</sup> In general, though, under an entity-based section, Nate’s outside basis will have no effect on the partnership’s basis in the property it owns (so called “inside basis”).<sup>118</sup> When the partnership sells that property, any gain will be allocated to all the partners, including Nate, in proportion to their interests (unless a special allocation is in effect).<sup>119</sup> When partnership property is substantially appreciated and Nate’s purchase price for the interest reflects that appreciation, this arrangement can result in Nate being overtaxed. That is, he could pay tax on the appreciation (when realized on sale of the partnership assets) despite having already paid for the appreciation (when he bought the partnership interest).

To prevent this apparent unfairness, Congress enacted a relief regime. If a partnership has filed an election with the IRS,<sup>120</sup> the partnership’s inside basis is adjusted to reflect the outside basis of the new partner, but only as to the new partner (Nate).<sup>121</sup> With Nate’s outside basis and the partnership’s inside basis harmonized, the prospect of overtaxation is mitigated.

Thus, considerable precision is achieved – at least in theory. But is it worth it? There are four reasons why it is not. First, the problem addressed by the relief regime is only temporary. Gain allocated to Nate on account of the sale of partnership property increases his outside basis.<sup>122</sup> That higher basis will benefit Nate later. For example, it may allow him to deduct additional

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addition to § 751(a), § 751 includes § 751(b) – also exceedingly complex. See Monte A. Jackel & Avery I. Stok, *Blissful Ignorance: Section 751(b) Uncharted Territory*, 98 TAX NOTES 1557, 1558 (2003).

<sup>115</sup> However, some complexity can follow the sale of S corporation stock because of rules allocating income and expense among shareholders for the year in which an ownership change occurs. See I.R.C. § 1377(a).

<sup>116</sup> Roughly speaking, basis measures a taxpayer’s investment in an asset. Basis is important for many purposes. For example, it is central to calculating a taxpayer’s gain or loss on the sale or exchange of property. See I.R.C. § 1001(a), (b).

<sup>117</sup> I.R.C. §§ 742, 752 & 1012.

<sup>118</sup> I.R.C. § 743(a).

<sup>119</sup> I.R.C. §§ 701, 702(a) & 704(b).

<sup>120</sup> I.R.C. § 754.

<sup>121</sup> I.R.C. § 743.

<sup>122</sup> I.R.C. § 705(a)(1)(A).

pass-through losses from the partnership,<sup>123</sup> or it may increase his deductible loss or decrease his taxable gain when Nate later sells his partnership interest.<sup>124</sup> If Nate overpays initially, he recovers it later.

Second, Nate could protect himself against even the temporary harm. The outside basis/inside basis disequilibrium is no secret. Experienced buyers or their experienced tax advisors should be aware of it (though, of course, many are not). Being aware of it, they can readily avert the problem. A built-in tax disadvantage would make the partnership interest less valuable. An astute Nate thus would pay less to buy that interest, minimizing or eliminating the perceived problem.

Third, even were there a problem that requires correction, the relief mechanism Congress fashioned is less effective in practice than it is in theory. Some partners, partnerships, and their advisors do not know about the relief regime. Even when they do, they sometimes choose not to make the election required to trigger the relief. That choice sometimes reflects the fact that the tax interests of different partners are adverse.<sup>125</sup> That choice, at other times, reflects sheer frustration with an overly complicated mechanism. Many partnerships decide to omit the election and its consequent relief regime simply because these mechanisms are seen as more trouble than they're worth. The bother of going through the steps is disproportionate to the benefit of doing so.

Fourth, the mechanism Congress crafted adds considerably to the complexity of Subchapter K.<sup>126</sup> When a regime corrects a problem that would be only temporary in any event, when taxpayers themselves could avoid the problem without any special statutory relief, and when the web of correction has large holes, the correction is not worth having in the Code. Promoting simplicity would be the wiser choice here than chasing after complicated theoretical perfection.

## 2. *Proposal*

Why does the United States need *two* principal pass-through regimes? We could survive with only one; indeed, we'd be better off with only one. The Ship of State would continue to sail smoothly under two, instead of three, principal entity taxation regimes: one (Subchapter C) for entities separate from their owners and one other for pass-through vehicles.<sup>127</sup>

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<sup>123</sup> A partner may deduct pass-through losses only to the extent of his or her outside basis. I.R.C. § 704(d). So, the higher Nate's outside basis, the more pass-through losses he may deduct.

<sup>124</sup> See I.R.C. § 1001(a).

<sup>125</sup> When a Section 754 election is in place, Section 743(b) adjustment is compelled, not optional. If Nate bought his interest at a low price, the "relief" regime could cause inside basis to be *reduced* as to him. The relief mechanism can hurt new partners, just as it can help them.

<sup>126</sup> One has but to read – or attempt to read – the applicable regulation, Treas. Reg. § 1.743-1 (2002), to form a firm conviction of the complexity of the relief regime.

<sup>127</sup> I am not proposing abolition of highly specialized pass-through regimes like RICs and REITs (see *supra* note 87), hence the reference to "principal" pass-through regimes. This is not to deny, however, that reform opportunities exist as to such specialized regimes also. For one proposal, see Clarissa C. Potter, *A Wrench or a Sledgehammer? Fixing FASITs*, 56 SMU L. REV. 501 (2003).

If this proposal is adopted, which of the two major pass-through regimes should survive? Many commentators think that partnerships – or limited liability companies taxed as partnerships<sup>128</sup> – are the better entity-form choice for taxpayers.<sup>129</sup> Yet, despite predictions of their demise,<sup>130</sup> S corporations continue to be formed. Indeed, there are more S corporations than there are partnerships and LLCs.<sup>131</sup>

The reader will have deduced (correctly) that I prefer Subchapter S to Subchapter K because the former is easier for taxpayers to apply and for IRS to enforce. Thus, were we just to abolish one of the two and leave the other unchanged, I would urge abolition of Subchapter K. But, for me, which regime survives is secondary to making sure that only one survives. Let it be Subchapter K, Subchapter S, or some amalgam that incorporates the best features of both.<sup>132</sup> But let there be only one.

In a simplified environment, taxpayers will encounter reduced costs and greater certainty. In addition, freed to focus its attention and resources more narrowly, the IRS will improve its application of the Code. IRS audit coverage of pass-through entities is (put generously) spotty, even lower than its general audit coverage.<sup>133</sup> One of the reasons for this is that, even within the IRS, there are not enough people who understand the provisions governing taxation of

<sup>128</sup> An LLC with more than one owner may elect to be treated as either a corporation or a partnership for federal income tax purposes. Treas. Reg. § 301.7701-3(a) (2002). If it files no election, it will be treated as a partnership. *Id.* § 301.7701-3(b)(1).

<sup>129</sup> E.g., COVEN, PERONI & PUGH, *supra* note 100, at 681; Jerome Kurtz, *The Limited Liability Company and the Future of Business Taxation: A Comment on Professor Berger's Plan*, 47 TAX L. REV. 815, 818 (1992) (describing LLC's as "tax Nirvana").

<sup>130</sup> E.g., Jeffrey A. Maine, *Evaluating Subchapter S in a "Check-the-Box" World*, 51 TAX LAW. 717, 729-30 (1998) (suggesting that S corporations will be "push[ed] . . . to the side"); Schwidetzky, *supra* note 93; Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679, 1684 (1996) (wondering whether there is "any continuing need for Subchapter S").

<sup>131</sup> Despite the "conventional wisdom" that recommends LLCs, "the contrary reality in tax-land is that either the [C corporation or S corporation] tends in most market segments to be the tax entity of choice for small businesses conducted in an entity form rather than as a sole proprietorship." John W. Lee, *A Populist Political Perspective of the Business Tax Universe: "Hey the Stars Might Lie but the Numbers Never Do,"* 78 TEX. L. REV. 885, 887 (2000).

Based on returns filed for the year 2000, there were approximately 872,000 general partnerships, 349,000 limited partnerships, and 719,000 LLCs as against 2,860,000 S corporations and 2,184,000 C corporations. Sheldon I. Banoff & Richard M. Lipton (eds.), *Revisiting What's More Popular: Partnerships, LLC's, or S Corporations*, J. TAX'N, Sept. 2003, at 189, 190 (citing Joint Comm. on Taxation report, JCX-62-03, June 18, 2003).

The figures are not directly comparable, however. For instance, half or more of all S corporations have a single owner. Susan M. Whitman, *S Corporation Returns, 1994*, 16 IRS STAT. INCOME BULL. 38, 39-40 (1997). Partnerships, of course, must have more than one owner.

<sup>132</sup> For suggested improvements to the partnership tax rules, see William B. Brannan, *The Subchapter K Reform Act of 1997*, 75 TAX NOTES 121 (1997); Philip F. Postlewaite & John S. Pennell, *JCT's Partnership Tax Proposals – "Houston, We Have a Problem,"* 76 TAX NOTES 527 (1997); Joint Comm. on Taxation, *Review of Selected Entity Classification and Partnership Tax Issues* (JCS-6-97) (1997); Ernest & Young LLP, *Analysis of the Administration's Partnership Proposals*, 84 TAX NOTES 103 (1999).

<sup>133</sup> In FY 2002, the supposed audit rate for all returns was 0.48%, while the audit rates for partnership and S corporation returns were 0.26% and 0.39%, respectively. Internal Reve-

pass-through entities (particularly partnerships) and their owners.<sup>134</sup> Improving the IRS's application of the pass-through entity rules would benefit both the federal fisc (when the IRS knows enough to make proper adjustments to return inaccuracies) and taxpayers (when the IRS knows enough to omit improper adjustments it might otherwise have proposed or to concede, short of trial, improper adjustments it had proposed).

## *B. Eliminate the TEFRA Partnership Audit Rules*

### *1. Complexity*

We have just reviewed complexity in the substantive rules governing entity taxation. It is matched by complexity in the procedural rules as to entity taxation. While there are three major substantive regimes (Subchapters C, K, and S), there are five procedural regimes:

(1) As we have seen, C corporations are considered taxpayers separate from their owners for substantive purposes. This conceptualization is carried over into the procedural realm. The corporation files income tax returns,<sup>135</sup> and the IRS audits those returns. If the IRS believes a return understates tax liability, it issues a notice of deficiency to the corporation. The corporation brings a court case disputing the deficiency notice. If the IRS prevails, it collects the additional liability from the corporation. If the corporation's assets are insufficient, the IRS might be able to seek secondary collection from the corporation's shareholders,<sup>136</sup> but only under a narrow set of circumstances, usually involving the transfer of corporate assets to the shareholders.<sup>137</sup>

The procedural rules as to partnerships and their owners are not so easily stated, in part because of the vexing "entity versus aggregate" question. Income taxation of partnerships and partners may be any of pure aggregate (audit and litigation at partner level), mixed aggregate and entity (audit and litigation involving both the partners and the partnership), or pure entity (audit and litigation at the partnership level).

(2) Originally, pure aggregate theory prevailed. Although partnerships file annual "returns,"<sup>138</sup> they are really only information returns since partnerships (as pass-through entities) have no income tax liability. The main purpose of the

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nue Service, 2002 DATA BOOK 17, table 10, available at <http://www.irs.gov/pub/irs-soi/02databk.pdf> (last visited June 12, 2004).

<sup>134</sup> The explanation for low audit coverage certainly is not that pass-through entity taxation is already an area of high taxpayer compliance. "Most scholars of partnership taxation have a nagging suspicion that much, perhaps most, of Subchapter K is honored principally in the breach." Lawrence Lokken, *As the World of Partnership Taxation Turns*, 56 SMU L. REV. 365, 365-66 (2003); see also George K. Yin, *The Future Taxation of Private Business Firms*, 4 FLA. TAX REV. 141 (1999).

<sup>135</sup> IRS Form 1120 (2003), available at <http://www.irs.gov/pub/irs-pdf/f1120.pdf>.

<sup>136</sup> This is principally done through the device of transferee liability. See I.R.C. § 6901 (1982).

<sup>137</sup> Absent such transfer or other special circumstance, a shareholder is not considered a fiduciary liable for the corporation's unpaid tax liabilities. *E.g.*, *Grieb v. Comm'r*, 36 T.C. 156, 163 (1961).

<sup>138</sup> IRS Form 1065 (2003), available at <http://www.irs.gov/pub/irs-pdf/f1065.pdf>.



partnership return is to report to the IRS how much of each item of income, deduction, and credit is allocable to each partner.<sup>139</sup>

Under the original regime, any audit was of the return(s) filed by the partner(s).<sup>140</sup> The IRS agent performing the audit would consult the partnership's return and the relevant K-1, but only as sources bearing on the partner's liability. If the agent concluded that partnership items were incorrectly reported on the partner's return,<sup>141</sup> the IRS issued a statutory notice of deficiency to the partner, who then could challenge it in court. If the IRS prevailed, the IRS collected the deficiency from the partner's assets. One of those assets may be the partnership interest. However, the accepted wisdom is that the federal tax lien operates only as a charging order against the partnership interest. That is, the IRS would be entitled, standing in the partner's shoes for this purpose, to levy on any distributions from the partnership to the partner but would not be able to compel the partnership to make such a distribution or to levy on the assets of the partnership itself.<sup>142</sup>

(3) In 1982, Congress enacted a new partnership audit and litigation regime in the Tax Equity and Fiscal Responsibility Act ("TEFRA").<sup>143</sup> In the TEFRA procedures, Congress flirted with entity-level audit and litigation of partnership issues but could not bring itself to fully embrace them.<sup>144</sup> The first of the relevant sections provides that, with exceptions to follow, "the tax treatment of any partnership item . . . shall be determined at the partnership level."<sup>145</sup> The second section generally requires partners to take positions on their own returns that are consistent with positions taken on the partnership's return.<sup>146</sup>

Audit occurs at the partnership level. The IRS's determinations are set forth in an FPAA (final partnership administrative adjustment), the functional equivalent of the statutory notice of deficiency.<sup>147</sup> The partnership may challenge the FPAA in the Tax Court, district court, or the Court of Federal

<sup>139</sup> The vehicles for this are the Schedules K-1 attached to the Form 1065. For discussion of the IRS's fitful attempts to match K-1's against partners' returns, see Johnson, *supra* note 9, at 1018.

<sup>140</sup> See generally CONFERENCE REPORT TO ACCOMPANY H.R. 4961, TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, H.R. Rep. No. 760, 97th Cong., 2d Sess. 599 (1982).

<sup>141</sup> This may happen either because: (1) the amounts allocated to the partner on the Schedule K-1 are correct, but the partner claims different amounts on his return; or (2) the amounts on the K-1 are incorrect.

<sup>142</sup> See, e.g., *United States v. Craft*, 535 U.S. 274, 286 (2002).

<sup>143</sup> Pub. L. No. 97-248, 96 Stat. 324 (1982) (partnership audit and litigation provisions codified at I.R.C. §§ 6221-34). TEFRA, by the way, is my all-time favorite statutory title. It is a source of great comfort to know that, since 1982, our taxes have been equitable and our government has been fiscally responsible.

<sup>144</sup> For description of the TEFRA partnership procedures, see Claudine Ausness, *Partnership Level Proceedings: Policies, Procedures and Planning*, 72 Ky. L.J. 89 (1983/1984); Carmen D. Tucker Bakarich, *Auditing the Partnership: The Rules and the Complications*, 31 WASHBURN L.J. 18 (1991); L. Glenn Worley, *The Tax Treatment of Partnership Items Act of 1982: Pragmatic Procedures for Determining Partners' Shares of Partnership Income*, 14 MEMPHIS ST. U. REV. 1 (1983).

<sup>145</sup> I.R.C. § 6221 (West 2004).

<sup>146</sup> I.R.C. § 6222(a). However, the partner may take an inconsistent position if she files a statement with the IRS identifying the inconsistency. I.R.C. § 6222(b)(1).

<sup>147</sup> I.R.C. § 6223(a)(2).

Claims.<sup>148</sup> The partnership is represented in these and other matters by a point person, the TMP (tax matters partner).<sup>149</sup>

Yet those entity-based approaches are modified by aggregate-based notice and participation rules. The IRS must mail to partners copies of the notice beginning the audit and of the FPAA.<sup>150</sup> Moreover, if the TMP files a petition contesting the FPAA each partner with an interest in the outcome of the proceeding<sup>151</sup> is treated as a party to the action and is allowed to participate in it.<sup>152</sup> If the TMP fails to timely file a petition, certain individual partners or a group of partners are allowed additional time to file a petition.<sup>153</sup> The TMP, certain individual partners, and a group of partners may appeal an adverse decision by the trial court.<sup>154</sup>

However, as a result of a number of exceptions and special rules, the TEFRA regime does not apply to all partners and partnerships. For example, entities that elect out of Subchapter K<sup>155</sup> are outside the TEFRA procedures since they are not required to file partnership returns.<sup>156</sup>

More importantly, the TEFRA procedures do not apply to so called small partnerships, i.e., partnerships with ten or fewer partners, each of whom is a natural person (and may not be a nonresident alien) or a natural person's estate and each of whom has a share of each partnership item which is the same as her share of every other item.<sup>157</sup> However, a partnership within this definition may elect into the TEFRA regime.<sup>158</sup>

The TEFRA rules may not apply to some particulars even if they apply to the partnership generally. Generically, not all items on the partner's return will be partnership items subject to the TEFRA procedures.<sup>159</sup> Other items may be partnership items generically, but be removed from that category because of special, defined circumstances.<sup>160</sup>

When, for any reasons, the TEFRA rules do not apply, we are kicked back to the original, pre-TEFRA rules. That is, any audit and litigation will proceed at the partner-level, under an aggregate theory of partnership procedure.

(4) Neither a pure aggregate approach nor even a mixed aggregate-entity approach is feasible when the partnership has hundreds or even thousands of partners. Thus, in 1987, Congress enacted a special, pure entity approach.<sup>161</sup> It applies to "publicly traded partnerships": partnership interests which "are traded on an established securities market" or "are readily tradable on a secon-

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<sup>148</sup> I.R.C. § 6226(a).

<sup>149</sup> See I.R.C. §§ 6226(c), 6231(a)(7).

<sup>150</sup> I.R.C. § 6223(a).

<sup>151</sup> See I.R.C. § 6226(d).

<sup>152</sup> I.R.C. § 6226(c).

<sup>153</sup> I.R.C. § 6226(b).

<sup>154</sup> I.R.C. § 6226(g).

<sup>155</sup> See I.R.C. § 761.

<sup>156</sup> Temp. Treas. Reg. § 1.6031(b)-1T (2003).

<sup>157</sup> I.R.C. § 6231(a)(1)(B).

<sup>158</sup> I.R.C. § 6231(a)(1)(B)(ii).

<sup>159</sup> See I.R.C. § 6231(a)(3)-(5) (distinguishing partnership, nonpartnership, and affected items).

<sup>160</sup> See I.R.C. § 6231(b)-(c).

<sup>161</sup> Revenue Act of 1987, Pub. L. No. 100-203, § 10211, 101 Stat. 1330-403 (1987).

dary market (or the substantial equivalent thereof)."<sup>162</sup> Such partnerships are "treated as corporations";<sup>163</sup> that is, they are handled procedurally at the partnership level exclusively.<sup>164</sup>

(5) Unlike partnerships which are wholly pass-through vehicles, S corporations<sup>165</sup> do pay several types of income tax at the entity level.<sup>166</sup> As to pass-through items, though, an aggregate approach applies, mirroring the owner-level procedures originally applied (and still applied when the TEFRA and publicly traded partnership regimes are inapposite) to partnerships.

It has not always been thus. In the same year as TEFRA, a different statute enacted somewhat parallel procedures for S corporations.<sup>167</sup> Those parallel S corporation procedures were repealed, however, for tax years beginning in or after 1997.<sup>168</sup>

In the multi-tiered system just described, there is little doubt at which level the greatest complexity resides. The other levels creak from time to time, but the TEFRA regime groans continually. The notice and participation rules create a variant on forms complexity,<sup>169</sup> with the IRS, the courts, the TMP, the other partners, and their advisers all bearing some of the inconvenience and expense.<sup>170</sup>

But that irritant is far eclipsed by the outcome complexity engendered by TEFRA. The points of controversy as to the TEFRA rules have been myriad. They divide into two classes: (1) uncertainties internal to specific TEFRA rules and (2) uncertainties as to the interaction of the TEFRA procedures and other procedures.

As to particular sections, numerous TEFRA rules have provoked controversy.<sup>171</sup> Courts often disagreed with each other on the issues. Sometimes,

<sup>162</sup> I.R.C. § 7704(b).

<sup>163</sup> I.R.C. § 7704(a).

<sup>164</sup> For additional discussion of this regime, see COVEN, PERONI, & PUGH, *supra* note 100, at 811-13.

<sup>165</sup> S corporations are organized under the usual state corporation laws, but they must meet defined eligibility criteria and file an election to be taxed under Subchapter S. See I.R.C. §§ 1361(a)(1), (b), 1362(a)-(c).

<sup>166</sup> See I.R.C. §§ 1363(d), 1374, 1375.

<sup>167</sup> Subchapter S Revision Act of 1982, Pub. L. No. 97-354, § 4(a), 96 Stat. 1669, 1691-92 (1982) (formerly codified at repealed I.R.C. §§ 6221-45).

<sup>168</sup> Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1307(c)(1), 110 Stat. 1755, 1781 (1996).

<sup>169</sup> Despite this, some believe that the notice and participation opportunities do not go far enough. For a proposal to expand them, see Don R. Spellman, *Taxation Without Notice: Due Process and Other Notice Shortcomings with the Partnership Audit Rules*, 52 TAX LAW. 133 (1998).

<sup>170</sup> The TEFRA regime has "generated thousands of billable and non-billable hours of work for tax practitioners who had to learn the intricacies of partnership items, affected items, and different statute of limitations rules. Even after all this study, however, the exact meaning of these new rules was far from clear." Burgess J.W. Raby & William L. Raby, *TEFRA Partnership Rules: The Solution Becomes the Problem*, 88 TAX NOTES 795 (2000).

<sup>171</sup> For a description of some of the many areas of uncertainty and conflict, see *id.*; Tim A. Tarter & Terrance D. Woolston, *TEFRA Audit Provisions: Don't Wait for an Audit To Understand Them*, 84 TAX NOTES 587 (1999); F. Brook Voght, Frederick H. Robinson & Michael E. Baillif, *New Rules for TEFRA Partnerships Provide More Flexibility in Resolving Disputes with IRS*, J. TAX'N 279 (1998).

decisions of the same court have been in conflict. This confusion is all the more regrettable because promoting consistency and uniformity was a central goal of Congress in enacting the TEFRA procedures.<sup>172</sup>

Similar outcome complexity existed under the quasi-TEFRA audit and litigation rules that governed S corporations between 1983 and 1996. A striking example was the "small S corporation" exception. The 1983 statutes enacting these rules<sup>173</sup> were sparse, and the regulation governing the exception was not effective until 1987.<sup>174</sup> The case law was in disarray:

- At first, the Tax Court held that a small S corporation exception existed but applied only to single-shareholder corporations.<sup>175</sup>
- Some other courts disagreed with the Tax Court, some holding that the exception was broader,<sup>176</sup> others holding that no small S corporation exception existed at all.<sup>177</sup>
- The Tax Court later reversed itself, holding that the small S corporation exception did not exist until the effectiveness of the Regulation.<sup>178</sup>

As to TEFRA/non-TEFRA coordination, partners' returns contain items from partnership operations as well as items from other activities. Examinations of the different items will proceed on two different tracks: TEFRA and non-TEFRA. This has led to problems. Indeed,

it is virtually impossible to have two entirely discrete tax procedural regimes when there are so many ways that partnership items can operate on a taxpayer's affected items and indirectly influence even non-partnership items. The potential for overlapping effects and hidden boomerangs is mind-numbing.<sup>179</sup>

Of course, most new legal regimes entail transitional uncertainties, but TEFRA's complexity has proved to be far from merely transitory. Now, over two decades since enactment of the TEFRA unified partnership procedures, many significant issues remain unsettled. The outcome complexity of the TEFRA procedures remains daunting.<sup>180</sup>

<sup>172</sup> *E.g.*, *Kaplan v. United States*, 133 F.3d 469, 471 (7th Cir. 1998) (citing legislative report).

<sup>173</sup> *See supra* note 167.

<sup>174</sup> Former Temp. Treas. Reg. § 301.6241-1T(c)(2)(i) (exempting from the quasi-TEFRA rules S corporations with 5 or fewer shareholders; effective for tax years for which the return was due on or after January 30, 1987).

<sup>175</sup> *E.g.*, 111 West 16th St. v. Comm'r, 90 T.C. 1243 (1988); *Blanco v. Comm'r*, 89 T.C. 1169 (1987).

<sup>176</sup> *E.g.*, *Arenjay v. Comm'r*, 920 F.2d 269 (5th Cir. 1991) (exception exists for S corporations with ten or fewer shareholders); *see also* *Fehlhaber v. Comm'r*, 954 F.2d 653 (11th Cir. 1992) (stating no clear theory).

<sup>177</sup> *E.g.*, *Miller v. Comm'r*, 710 F. Supp. 1377 (N.D. Ga. 1989).

<sup>178</sup> *E. States Cas. Agency, Inc. v. Comm'r*, 96 T.C. 773 (1991).

<sup>179</sup> *Voght, Robinson & Bailif, supra* note 171, at 279-80.

<sup>180</sup> For an example, *see* *Raby & Raby, supra* note 170, at 795 ("it becomes apparent that the statute of limitations rules, in particular, are still not settled even after 18 years") (comparing *GAF Corp. v. Comm'r*, 114 T.C. 519 (2000), and *Rhone-Poulenc Surfactants & Specialties, Ltd. v. Comm'r*, 114 T.C. 533 (2000), *appeal dismissed & remanded*, 249 F.3d 175 (3d Cir. 2001)).

## 2. Proposal

The TEFRA partnership procedures are the worst portion of the entity audit and litigation process. The complexity they spawn is not justified by any compelling need. The TEFRA procedures should be abolished.

As usual, some history is useful. The TEFRA partnership rules were a response to the proliferation of individual tax shelters in the 1960s through 1980s. Unlike the current wave of shelters involving "tax products" more or less tailored to publicly traded corporations and certain high-income individuals,<sup>181</sup> the earlier wave of tax shelters involved mass marketing: many thousands of partnerships, each with dozens, often hundreds of "investors." This created an unprecedented paperwork burden on the IRS. Once it had identified a shelter offering inflated tax benefits, the IRS would have to identify the taxpayers participating in it, then pull, coordinate, and adjust their returns. The difficulties were compounded by the fact that partners in the same partnership often were located in many different IRS districts. Especially in the early years, the IRS was unable to handle all the paper. Many thousands of returns containing shelter items went unexamined because the IRS could not process them within the statute-of-limitations period.<sup>182</sup>

For this reason, the IRS sought entity-level partnership audit procedures at least as early as 1978.<sup>183</sup> When the TEFRA procedures were enacted four years later, the administrative burdens of partner-level auditing was the key rationale offered.<sup>184</sup> However, this exigency probably was insufficient warrant for the TEFRA procedures in 1982, and it certainly is insufficient warrant for them now. Consider the following four points:

(1) In the lag between 1978 and 1982, or at least fairly shortly after 1982, the IRS and the courts had developed reasonably effective mechanisms for coordinating shelter returns. At the audit level, the IRS assigned numbers to shelters. It coordinated returns of individual partners in those shelters through the assigned numbers and related standardized notices, often controlled by designated point personnel.<sup>185</sup> At the litigation level, IRS Counsel developed coordinated national projects, standardized settlement positions, test cases coupled with subsequent "show cause" orders, and similar approaches. In short, Congress delayed during the time that unified procedures might have been helpful, then legislated at a time when alternative processes had greatly undercut the need for such procedures.

(2) Even if some need existed for effective unified procedures in 1982, what Congress enacted was far from effective. As we have noted,<sup>186</sup> the

<sup>181</sup> See *supra* text accompanying notes 40-43.

<sup>182</sup> The statute of limitations period is normally three years. See I.R.C. § 6501(a).

<sup>183</sup> See, e.g., *The President's 1978 Tax Reduction and Reform Proposals: Hearings Before the House Comm. on Ways and Means*, 95th Cong., 2d Sess., pt.1, at 280-90 (1978).

<sup>184</sup> See, e.g., STAFF OF JOINT COMM. ON TAXATION, 97TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 268 (Comm. Print 1982).

<sup>185</sup> These procedures worked well despite occasional glitches. See *Scar v. Comm'r*, 814 F.2d 1363 (9th Cir. 1987) (invalidating a notice of deficiency which, because of an inputting error as to the tax shelter's number, contained explanatory paragraphs relating to the wrong shelter).

<sup>186</sup> See *supra* text accompanying notes 161-164.

TEFRA procedures are not pure entity in nature, but instead mix entity and aggregate features in ways that are cumbersome and often unclear. These rules are an object lesson in "Be careful what you wish for. You may get it."

(3) If the 1982 legislation did do anything positive, its contribution was rendered unnecessary by 1986 legislation.<sup>187</sup> In that year, Congress enacted the passive activity loss rules. These rules prevent a taxpayer from using shelter deductions and credits to offset income from services and investment.<sup>188</sup> Thus, in large measure, the IRS need not examine and disallow shelter items. It doesn't matter whether those items are \$1,000 or \$1,000,000 as long as they are bottled up and unusable against the kinds of income potential "investors" are trying to shelter.<sup>189</sup> The passive activity loss rules effectively ended the first, mass-marketed wave of tax shelters. That being so, the original justification for the TEFRA rules has been outmoded for nearly 20 years.

(4) By the numbers, there is no important place in the partnership continuum where the TEFRA rules matter. The great bulk of partnerships have 10 or fewer partners.<sup>190</sup> There should not be severe difficulties in auditing such small partnerships at the owner level. In any event, partnerships of this size are permitted to opt out of the TEFRA regime, returning to owner-level treatment.<sup>191</sup> Additionally, the concern prompting enactment of the TEFRA regime centered on partnerships with many partners. Since 1987, the largest publicly traded partnerships have been subject to a different, pure entity regime.<sup>192</sup> Furthermore, the intermediate zone between "under 10 partners" and publicly traded partnerships is of limited significance. The TEFRA rules cannot be upheld by such a slender reed.

Compare the weak current justification for the TEFRA rules to the great complexity they impose. It is hard to resist the conclusion that "the 1982 changes may have become a greater procedural problem than what remains of the procedural problems they were adopted to solve."<sup>193</sup>

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<sup>187</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

<sup>188</sup> I.R.C. § 469(a)(1), (d), (h)(2).

<sup>189</sup> For a discussion of the passive activity loss rules, see Boris I. Bittker, Martin J. McMahon, Jr. & Lawrence A. Zelenak, *A Whirlwind Tour of the Internal Revenue Code's At-Risk and Passive Activity Loss Rules*, 36 REAL PROP., PROBATE & TRUST J. 673 (2002); Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615 (1998); Lawrence Zelenak, *When Good Preferences Go Bad: A Critical Analysis of the Anti-Tax Shelter Provisions of the Tax Reform Act of 1986*, 67 TEX. L. REV. 499 (1989); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1 (1988).

<sup>190</sup> Based on 1999 returns, general partnerships (of which there were about 889,000) had an average of four partners, limited partnerships (354,000) an average of twenty-five partners, limited liability partnerships (42,000) an average of five partners, and limited liability companies (589,000) an average of four members. JACK H. TAYLOR, REPORT FOR CONGRESS: PASS-THROUGH ORGANIZATIONS NOT TAXED AS CORPORATIONS (Cong. Res. Serv. Print 2002).

<sup>191</sup> See *supra* text accompanying notes 157-158.

<sup>192</sup> See *supra* text accompanying notes 161-164.

<sup>193</sup> Raby & Raby, *supra* note 170, at 795.

### C. Eliminate the Accumulated Earnings Tax

#### 1. Complexity

The fact that C corporations are treated as taxpayers separate from their shareholders leads to the possibility of double taxation. Profits can be taxed once (to the corporation) when earned, then a second time (to the corporation's shareholders) when they are distributed as dividends.<sup>194</sup>

To blunt the second level of tax, corporations may be tempted to omit or delay paying dividends.<sup>195</sup> This would be feasible when the shareholders do not have current need for the money, or if they prefer to receive the benefit of the profits through selling their stock rather than through receiving dividends,<sup>196</sup> or if they prefer to pass the benefit of the profits on to those who ultimately will inherit their stock.<sup>197</sup>

For the very reason that the taxpayer may deem forgone or delayed distribution desirable, the government deems it undesirable. The government has attempted to influence corporate dividend policies in part via the accumulated earnings tax ("AET").<sup>198</sup> Under it, a corporation which fails to distribute its earnings and profits will be liable for a penalty tax.<sup>199</sup> So, the taxpayer's choice is either to distribute profits (incurring shareholder-level tax in addition to the regular corporate income tax) or to retain the earnings (incurring the corporate-level penalty tax in addition to the regular corporate income tax).<sup>200</sup>

This design was given particular significance by the relationship between individual and corporate income tax rates. For much of our income tax history, the top rate on individuals considerably exceeded the top rate on corporations.<sup>201</sup> This created an incentive for the wealthy to generate income through owned or controlled corporations rather than in their individual capacities. The AET and related provisions<sup>202</sup> were intended to discourage this means of tax minimization.<sup>203</sup>

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<sup>194</sup> See I.R.C. §§ 11, 61(a)(7) & 301 (West 2004).

<sup>195</sup> Hearings on H.R. 1658, H.R. 2571, H.R. 3397, and H.R. 4448 Before Subcomm. On Select Revenue Measures of House Comm. on Ways and Means, 99th Cong. 22 (1986) (statement of J. Roger Mentz, Assistant Treasury Secretary for Tax Policy).

<sup>196</sup> The stock price should rise to the extent the corporation has retained, rather than distributed, its earnings. For most of our tax history, capital gains on sale of stock held for a sufficient period have been taxed less heavily than dividends.

<sup>197</sup> The heir will take an income tax basis in the stock equal to the stock's value as of the decedent's death. I.R.C. § 1014(a). Undistributed profits should increase that value, and therefore the heir's basis.

<sup>198</sup> I.R.C. § 531-37.

<sup>199</sup> I.R.C. § 531.

<sup>200</sup> As to this historic purpose, see *Ivan Allen Co. v. United States*, 422 U.S. 617, 624-25 (1975).

<sup>201</sup> Between 1913 (when the personal income tax began) and 1915, the highest rate for individuals was 7% while the highest rate for corporations was 1%. From 1916 to 1980, the difference between those top rates ranged between 13% and 65%. Jeffrey L. Kwall, *Subchapter G of the Internal Revenue Code: Crusade Without a Cause?*, 5 VA. TAX REV. 223, 223 (1985).

<sup>202</sup> The AET is part of Subchapter G, which also includes sections as to personal holding companies, I.R.C. §§ 541-47 (West 2004), and foreign personal holding companies, I.R.C. §§ 551-58.

<sup>203</sup> E.g., *United States v. Donruss Co.*, 393 U.S. 297, 308 (1969).

These purposes have been pursued, however, at the cost of complexity. The AET imposes considerable complexity on taxpayers, the IRS, and courts alike. Indeed, it engenders all three of the varieties of complexity we have explored.

(1) Detail Complexity: In general, the AET is applied to corporations “formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed.”<sup>204</sup> There is a rebuttable presumption that the corporation has been formed or availed of for this purpose if earnings and profits have been accumulated “beyond the reasonable needs of the business.”<sup>205</sup> Special rules address the definition of reasonable needs.<sup>206</sup>

The tax base for the AET is “accumulated taxable income,”<sup>207</sup> which is the corporation’s taxable income as computed for regular income tax purposes with specified modifications and minus both a “dividends paid deduction” and an “accumulated earnings credit.”<sup>208</sup> Lengthy rules describe the taxable income modifications,<sup>209</sup> the dividends paid deduction,<sup>210</sup> and the accumulated earnings credit.<sup>211</sup> Thus, determining whether a particular corporation in a particular year is liable for the AET and, if so, in what amount is an intricate process – the essence of detail complexity.

(2) Forms complexity: A variety of forms complexity exists in the elaborate information exchange mechanism the AET creates through its burden of proof rules. Before issuing to the corporation a statutory notice of deficiency asserting an AET adjustment, the IRS may mail the corporation a notification that such an adjustment is contemplated.<sup>212</sup> The corporation may reply by giving the IRS a statement setting out the grounds on which it relies for its position that the accumulation was not beyond its reasonable business needs.<sup>213</sup> In an ensuing Tax Court case, the burden of proof with respect to whether the accumulation was excessive is on the IRS if no pre-statutory notice notification was given to the taxpayer.<sup>214</sup> The burden shifts to the corporation either if such notification was given and the taxpayer failed to timely file a responsive statement or if a responsive statement was filed but it lacked sufficient detail.<sup>215</sup>

Whether a responsive statement contains sufficient detail often entails uncertainty. Thus, two steps have become common. First, the taxpayer often crafts a long responsive statement setting out purported future needs of the

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<sup>204</sup> I.R.C. § 532(a).

<sup>205</sup> I.R.C. § 533(a).

<sup>206</sup> I.R.C. § 537.

<sup>207</sup> I.R.C. § 531.

<sup>208</sup> I.R.C. § 535(a).

<sup>209</sup> I.R.C. § 535(b).

<sup>210</sup> I.R.C. § 561-65. In addition to dividends actually paid, *see* I.R.C. § 561(a)(1), the deduction includes a special creature known as consent dividends, necessitating a further set of rules, *see* I.R.C. § 565.

<sup>211</sup> I.R.C. § 535(c).

<sup>212</sup> I.R.C. § 534(b).

<sup>213</sup> I.R.C. § 534(c).

<sup>214</sup> I.R.C. § 534(a).

<sup>215</sup> *Id.*; Treas. Reg. § 1.534-2(b), (d) (2002). Congress enacted a general burden of proof rule for civil tax cases in 1998, but the Section 534 rules control over the general rule. *See* I.R.C. § 7491(a)(3).



business in minute detail. Second, after close of pleadings but before trial, the corporation and the IRS frequently submit cross-motions to the Tax Court arguing why the taxpayer's statement was or was not sufficiently detailed and asking the court to declare which party will bear the burden of proof at trial. The court then often issues an opinion resolving those motions.<sup>216</sup> Of course, the case itself remains to be tried; the opinion only resolves who will bear the burden of proof in the upcoming trial.

The elaborate procedures just described have some justification assuming we are to have an AET at all. AET cases usually turn on the intensely factual inquiry of what needs could reasonably be anticipated for the particular business in the years ahead. The procedures above serve as discovery devices, encouraging the parties to develop a full factual record on which the court can decide the case.

Nonetheless, the paperwork complexity is great. Given the IRS's pre-statutory notice notification, the corporation's responsive statement, the parties' cross-motions, and the Tax Court opinion as to location of the burden of proof, the cumulative costs in time, effort, and money often are substantial.<sup>217</sup>

(3) Outcome complexity: Even when the record is fully developed, the ultimate resolution of AET cases often is hard to predict. How much is enough? Are the needs asserted by the taxpayer real or pretextual? When does prudence slide into overcaution? Anyone who has taken a Torts course knows the "eye of the beholder" quality of "reasonable." Moreover, AET cases assess reasonableness through the always dark glass of the future.

In short, only incurably optimistic lawyers feel confident about victory in AET trials, and victory at trial affords only limited security since appellate reversals are common in AET cases.<sup>218</sup> Outcome complexity – like detail complexity and a variant of forms complexity – abounds in AET cases.

## 2. Proposal

The AET should be abolished. This is an easy sell, of course, to the sizeable segment of tax theorists who believe in "integration"; that is, elimination of two levels of tax on corporate earnings.<sup>219</sup> Yet integration remains controversial,<sup>220</sup> and the United States has not yet committed to it. The Joint Committee on Taxation, in its 2001 simplification study, expressly refrained from making

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<sup>216</sup> *E.g.*, *Gustafson's Dairy, Inc. v. Comm'r*, 69 T.C.M. (CCH) 1639 (1995); *Iowa School of Men's Hairstyling v. Comm'r*, 64 T.C.M. (CCH) 1114 (1992).

<sup>217</sup> *See, e.g.*, *Lee, supra* note 131, at 917-18 (noting transaction costs imposed on taxpayers by the AET).

<sup>218</sup> *E.g.*, *Myron's Ballroom v. United States*, 382 F. Supp. 582 (C.D. Cal. 1974), *rev'd & remanded sub nom.* *Myron's Enters. v. United States*, 548 F.2d 331 (9th Cir. 1977); *Ivan Allen Co. v. United States*, 349 F. Supp. 1075 (N.D. Ga. 1972), *rev'd & remanded*, 493 F.2d 426 (5th Cir. 1974), *aff'd*, 422 U.S. 617 (1975); *Donruss Co. v. United States*, 384 F.2d 292 (6th Cir. 1967) (reversing and remanding district court decision), *rev'd & remanded*, 393 U.S. 297 (1969).

<sup>219</sup> *See, e.g.*, Stacy S. Shibao, *Applying the Accumulated Earnings Tax to a Publicly Held Corporation*: *Technalysis Corporation v. Commissioner*, 47 TAX LAW. 1061, 1073-74 (1994).

<sup>220</sup> For one of the classic studies of the issue, see U.S. DEP'T OF TREASURY, *INTEGRATION OF INDIVIDUAL AND CORPORATE TAX SYSTEMS* (Jan. 1992).

a recommendation as to AET elimination because of the unsettled state of the integration controversy.<sup>221</sup>

Abolition of the AET should not depend on integration. The AET should be ended even if we retain two levels of tax in the corporation context. Some of the reasons are well known, constituting the traditional case against the AET. Other reasons flow from the perspectives of administrability-based simplification. Below, I consider both types of reasons in four points.

(1) The historical justification for the AET has eroded sharply. In the last twenty-five years, the differential between the top individual income tax rate and the top corporate rate has largely evaporated.<sup>222</sup> In 2006, when legislation becomes fully phased in, the top individual rate and the top corporate rate both will be 35%.<sup>223</sup> Had such parity existed earlier, it is doubtful the AET would have been adopted.<sup>224</sup>

(2) There is a dearth of empirical support for the key assumptions that the existence of the AET significantly affects corporate dividend policy and that any such effect is beneficial. Dividend policies are strongly influenced by – often controlled by – economic, personal, and other factors, not by tax rules.<sup>225</sup> To the extent the AET does alter corporate behavior, the effect sometimes may be undesirable. In some cases in which the economically efficient decision would be to retain funds to fuel future growth, concern that the IRS and the courts might read “reasonable needs” narrowly could cause businesses instead to distribute the funds.<sup>226</sup>

Such traditional complaints about the AET are strongly reinforced by administrability-based simplification considerations. The theoretical justification for the AET is that it protects the revenue from erosion. In reality, the AET does not meaningfully increase tax revenues. Indeed, as argued below, it probably *lowers* them.

(3) The IRS sets up relatively few AET adjustments each year, and it has an uninspiring victory rate in the AET cases that are litigated. As a result, “the [AET] is not now, nor has it ever been, effective.”<sup>227</sup> There are a number of reasons for this. One is that competent in-house or outside tax advisers understand the game and guide corporations in constructing plausible paperwork, colorably establishing high future capital needs. Thus, well-advised companies usually have little fear of the AET.<sup>228</sup>

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<sup>221</sup> STAFF OF JOINT COMM. ON TAXATION, *supra* note 83, vol. II, at 237-38.

<sup>222</sup> Indeed, between 1986 and 1993, it was inverted, the top corporate rate being below the top individual rate. Gene Steuerle, *Will Corporate Taxes Survive?*, 72 TAX NOTES 1043 (1996).

<sup>223</sup> *Compare* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, § 101, 117 Stat. 752 (2003) (amending I.R.C. § 1 as to individual taxpayers) *with* I.R.C. § 11(b)(1) (corporate taxpayers).

<sup>224</sup> *See, e.g.*, Kwall, *supra* note 201, at 225 (arguing in part that the AET no longer serves its historical purposes).

<sup>225</sup> *See* Steven A. Bank, *Is Double Taxation a Scapegoat for Declining Dividends? Evidence from History*, 56 TAX L. REV. 463 (2003).

<sup>226</sup> *See, e.g.*, Kwall, *supra* note 201, at 235-37 & n.69, 260-61 (discussing inefficiencies produced by AET historically); Shibao, *supra* note 219, at 1073.

<sup>227</sup> Lee, *supra* note 131, at 917 n.174.

<sup>228</sup> *See, e.g.*, JEROLD L. WALTMAN, *POLITICAL ORIGINS OF THE U.S. INCOME TAX* 108 (1985).

Another powerful factor is the reluctance of judges to substitute their own or the IRS's judgment for the business judgment of the taxpayer. Such deference is natural since the taxpayer – not judges or administrators – is closest to the business and best knows its experience and prospects. From an early date, this was recognized as a significant problem for the IRS in AET litigation.<sup>229</sup> It continues to be so more modernly, both as to the AET<sup>230</sup> and other types of issues involving IRS second-guessing taxpayers' business judgment.<sup>231</sup>

(4) As noted, AET cases are highly fact-intensive. If the IRS fails to invest enough Examination and Counsel time to fully develop those facts, it will likely lose the case. If it *does* invest the required time, it will still likely lose in a larger sense even if it wins the particular case. That is because of opportunity costs. IRS resources are distinctly limited. Investing hundreds or thousands of hours in an AET case means that time can't be invested elsewhere where the revenue pay-off would have been higher.

One of the AET cases I was involved in when employed by the IRS Chief Counsel's Office burns in my mind as an example.<sup>232</sup> The taxpayer was a dairying operation. It asserted future needs for capital involving expansion of the herd, pollution control, equipment acquisition, capital construction, land development, debt retirement, and self-insurance. The taxpayer and the IRS did the discovery dance described above, and the Tax Court ruled (on the cross-motions) that the taxpayer bore the burden of proof at trial.<sup>233</sup> When the case ultimately was tried, however, the taxpayer met that burden. The Tax Court held that the earnings and profits accumulation was reasonable and the corporation owed no AET.<sup>234</sup>

I can only guess at the time and money the taxpayer had to expend in the case. For its part, the IRS expended hundreds (if not thousands) of hours on the case during audit, administrative appeal, and litigation. That large investment of time yielded zero to the federal coffers. The effective redeployment of those resources might well have produced substantial revenue. This story has been

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<sup>229</sup> See, e.g., Hearings on H.R. 12395 (Revenue Act, 1936) Before Senate Finance Comm. (pt. 4), 74th Cong., 2d Sess. 69 (1936) (statement of Arthur H. Kent, Acting IRS Chief Counsel).

<sup>230</sup> E.g., *Myron's Enters. v. United States*, 548 F.2d 331, 334 (9th Cir. 1977) ("A court should be particularly wary of overturning a finding of a trial court *supporting* the taxpayer's determination of its anticipated business needs, since, in the first instance, the 'reasonableness of the needs is necessarily for determination by those concerned with the management of the particular enterprise. This determination must prevail unless the facts show clearly the accumulations were for prohibited purposes.'") (quoting *Henry Van Hummell, Inc. v. Comm'r*, 364 F.2d 746, 749 (10th Cir. 1966), *cert. denied*, 386 U.S. 956 (1967)).

<sup>231</sup> See, e.g., Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 415-16 (1996) (finding that the IRS loses the majority of litigated cases as to the reasonableness of compensation paid and deducted by a business).

<sup>232</sup> I rendered legal advice to the revenue agent during the examination. When I left IRS Counsel to teach, the case was assigned to another attorney who represented the IRS during the litigation.

<sup>233</sup> *Gustafson's Dairy, Inc. v. Comm'r*, 69 T.C.M. (CCH) 1639 (1995).

<sup>234</sup> *Gustafson's Dairy, Inc. v. Comm'r*, 74 T.C.M. (CCH) 1224 (1997). For discussion of the case, see John S. Ball & Beverly H. Furtick, *Defending the Accumulated Earnings Tax Case*, FLA. B.J., Dec. 1998, at 28.

repeated in many AET cases. The AET does not effectively protect the fisc. Because of its opportunity costs, it may well lower the federal tax take.

Perhaps there is some theoretical warrant for the AET. But when one compares it to the reality of the complexity costs the AET imposes on all parties, the game may not be worth the candle. When one adds the further facts of the IRS's low AET win-rate and its high opportunity costs, I believe the case becomes overwhelming. Abolition of the AET is an administrability-based simplification that would help both taxpayers and the Government.

## VI. CONCLUSION

Despite the all too visible warts of the federal income tax and its many real disfunctionalities, some form of that tax is likely to continue to be the centerpiece of our system of taxation for the foreseeable future. Thus, at least part of our attention and energy should be devoted to improving that tax.

In improving the income tax, simplification should command a high priority, and the notion of administrability should receive considerable emphasis as a guide on the road to simplification. Administrability washes from our eyes the pixie dust of what we hope tax rules will achieve and draws our gaze instead to the realities of what those rules actually do achieve.

There are sound precedents, examples of signal improvements to the income tax in existing sections based on administrability. Those examples do not come close to exhausting the field of possibilities. Herein, I have proposed three other candidates for administrability-based simplification, all involving the substantive and procedural rules governing income taxation of businesses. Numerous additional candidates exist in this and other areas.

More important than amendment of any particular Code section, though, would be an attitudinal change. We must become more willing to choose rough justice rules that taxpayers and the IRS can apply over theoretically more precise rules that they can't apply. In crafting tax statutes and regulations, we must more often be driven by hard realities than by comfortable illusions. We may not be able to tear out the federal income tax by its roots, but, by sensibly pruning its branches, we can make it a healthier plant.