[COMMITTEE PRINT]

ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS

A REPORT

PREPARED BY THE STAFF FOR THE

JOINT COMMITTEE ON TAXATION

SUBMITTED TO THE

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

AND THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

PURSUANT TO

SECTION 507 OF

PUBLIC LAW 94-455

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recommendations should be made only after there has been a comprehensive analysis of the possible impact upon tax equity and the economy. In many respects, solutions to these issues can best be formulated through the normal legislative process which would permit consideration of the suggestions and comments by the public.

"The Joint Committee recognizes the importance and desirability of simplifying the tax laws. In this light, the Joint Committee is releasing this staff-prepared report to the House Committee on Ways and Means and the Senate Committee on Finance and to the public in order to promote consideration, discussion, and recommendations by the public, tax practitioners, educators, the Administration, and Members of Congress concerning simplification of the tax laws and the potential impact upon other important tax policy objectives. The staff report has not yet been thoroughly reviewed by the Joint Committee Members, and, therefore, it is not intended to be a statement of the views of the committee.

"The principal purpose of the staff report is to present a general description of some of the important issues which would arise in connection with a review of certain provisions of present law for simplification purposes. As such, the report does not make recommendations with respect to specific tax issues. It does include

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CHAIRMAN AL ULLMAN (D. OREGON) AND VICE CHAIRMAN RUSSELL B. LONG (D. LOUISIANA), JOINT COMMITTEE ON TAXATION, U.S. CONGRESS, ANNOUNCE THE RELEASE OF A STAFF-PREPARED REPORT ON ISSUES IN SIMPLIFICATION OF THE INCOME TAX LAWS

The Honorable Al Ullman (D. Oregon), Chairman, and the Honorable Russell B. Long (D. Louisiana) Vice Chairman, Joint Committee on Taxation, U.S. Congress, today announced the release of a staff-prepared report on issues in simplification of the income tax laws. The Joint Committee met on September 19, 1977, for a briefing on the staff report and agreed to release the report as a staff-prepared document.

Background of Report

Section 507 of the Tax Reform Act of 1976 (Public Law 94-455) requires the Joint Committee on Taxation to make a study regarding simplifying and indexing the Federal tax laws. The study is to include a consideration of whether rates of tax can be reduced by repealing any or all tax deductions, exemptions, or credits. The provision also requires the committee to submit a report of its study, together with recommendations, to the Committee on Finance of the Senate and to the Committee on Ways and Means of the House of Representatives.

This staff report is made pursuant to this provision of the Tax Reform Act of 1976 and deals with simplification of the tax laws.

Joint Committee Comments on Report

The Joint Committee statement on the staff report included the following comments:

"A proper review of tax provisions for simplification purposes would necessarily involve a review of the possible impact of simplification changes on other important tax policy objectives. These other considerations include the possible impact on tax equity and other economic or social goals. Tax simplification cannot be considered as an isolated issue since simplification objectives will often conflict with some of these other objectives.

"The Joint Committee believes that specific simplification recommendations should be made only after there has been a comprehensive analysis of the possible impact upon tax equity and the economy. In many respects, solutions to these issues can best be formulated through the normal legislative process which would permit consideration of the suggestions and comments by the public.

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Staff Suggestions

Specifically, the staff suggestions are:

"1. Review of present law

"It is suggested that there be a periodic review of special tax provisions to see if their beneficial effects warrant the degree of complexity added to the tax system. Section V of the report describes some of the issues regarding simplification of the individual income tax. As a possible starting point of a review of present law for simplification purposes, some or all of the issues described in that section could be selected by the tax-writing committees for review.

"It is also suggested that there be periodic reviews of tax provisions to determine if structural improvements can be made to simplify the law.

"2. Analysis of legislative proposals

STATEMENT BY THE JOINT COMMITTEE ON TAXATION WITH RESPECT TO THE STAFF REPORT ON TAX SIMPLIFICATION

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The staff report also presents several possible base-broadening options for the individual income tax. This presentation shows the extent to which tax rates could be reduced if the income tax base were broadened by reducing or eliminating certain exclusions, deductions and credits. The options are only intended to be illustrative of the degree of rate reduction associated with various levels of base-broadening. The options presented are not intended as recommendations and do not represent the views of the committee or the staff as to what is desirable.

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"It is suggested that the Ways and Means Committee and Finance Committee require staff analysis of any possible complicating effects of each tax proposal considered by the committees.

"It is also suggested that the committees receive data and testimony concerning the possible effects of a proposal on tax complexity from the staff of the Treasury Department and the public. This data could include an estimate of additional paperwork which would result from the proposal and the compliance costs. In addition, it is suggested that the effect of a proposal on the tax forms be considered, whenever feasible, by the tax-writing committees. This could be done in certain cases by having the Internal Revenue Service, in consultation with tax policy officials of the Treasury Department, prepare sample tax forms which reflect the proposal."

Outline of Report

Section I of the report contains a summary of the study's findings and general suggestions for Congressional consideration. Section II contains a general discussion of tax simplification, including a review of the various meanings of simplification and possible conflicts between simplification and other tax policy objectives. Section III contains statistical data to indicate some general trends in the use and importance of the individual income tax, taxpayer error rates, and areas of significant controversy or uncertainty. Section IV outlines recent trends toward greater complexity of the tax laws. Under a broad topical approach, section V discusses some of the specific areas of complexity of the individual income tax under present law. Section VI contains a summary of recent legislation relating to tax simplification and other proposals. Section VII presents several possible base-broadening options for the individual income tax. This presentation shows the extent to which tax rates could be reduced if the income tax base were broadened by reducing or eliminating certain exclusions, deductions, and credits. The options are only intended to be illustrative of the degree of rate reduction associated with various levels of base-broadening. The options presented are not intended as recommendations and do not represent the views of the committee or its staff as to what is desirable. Finally, the Appendix contains material on estimates of Federal tax expenditures and a survey of recent tax literature relating to tax simplification.

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INTRODUCTION

Basis for Study

Section 507 of the Tax Reform Act of 1976 (Public Law 94–455) requires the Joint Committee on Taxation to make a study regarding simplifying and indexing the Federal tax laws. The study is to include a consideration of whether rates of tax can be reduced by repealing any or all tax deductions, exemptions, or credits. The provision also requires the committee to submit a report of its study, together with recommendations, to the Committee on Finance of the Senate and to the Committee on Ways and Means of the House of Representatives.

This staff report is made pursuant to this provision of the Tax Reform Act of 1976 and deals with simplification of the tax laws. This report does not cover the subject of indexing of the tax laws.

This report focuses on simplification issues relating to the Federal income tax, and primarily the individual income tax. The report does not address the specific issues that may be involved in simplification of Federal excise, employment, or estate and gifts taxes. However, some of the general observations concerning reasons for complexity of the income tax laws would be applicable to these taxes as well.

Procedure for Study

During the study, the staff of the Joint Committee reviewed previous tax simplification legislation and studies and proposals for legislation relating to tax simplification which have been made by the Treasury Department, other governmental agencies, professional groups, and commentators. In addition, the staff consulted with representatives of the Treasury Department, the Internal Revenue Service, the General Accounting Office, the Tax Study Group of the Commission on Federal Paperwork, and the Senate Select Committee on Small Business. Suggestions and comments also were received from Members of Congress and their staffs.

The staff also consulted with members of the Special Committee on Simplification of the Tax Section of the American Bar Association, the Task Force on Simplification and Basic Tax Reform of the American Institute of Certified Public Accountants, as well as representatives of the Chamber of Commerce of the United States, the Task Force on Simplification of The Tax Council, and the Public Citizens Tax Reform Research Group. The staff also met with other groups of interested individuals, including tax practitioners, businessmen, and other tax professionals.

The General Accounting Office, the Congressional Research Service of the Library of Congress, and the Office of Assistant Commissioner for Planning and Research of the Internal Revenue Service assisted in compiling statistical data and other research material.

Outline of Report

Section I of the report contains a summary of the study's findings and general suggestions for Congressional consideration. Section II contains a general discussion of tax simplification, including a review of the various meanings of simplification and possible conflicts between simplification and other tax policy objectives. Section III contains statistical data to indicate some general trends in the use and importance of the individual income tax; taxpayer error rates, and areas of significant controversy or uncertainty. Section IV outlines recent trends toward greater complexity of the tax laws. Under a broad topical approach, section V discusses some of the specific areas of complexity of the individual income tax under present law. Section VI contains a summary of recent legislation relating to tax simplification and other proposals. Section VII describes several possible options for broadening the income tax base and reducing the tax rates. Finally, the Appendix contains material on estimates of Federal tax expenditures and a survey of recent tax literature relating to tax simplification.

I. SUMMARY OF FINDINGS AND GENERAL SUGGESTIONS FOR CONGRESSIONAL CONSIDERATION

A. Summary of Findings

1. Nature of problem

Tax complexity means different things to different people. For some, it means being unable to understand the basic filing requirements or to comprehend forms and instructions. For others, it means having to maintain records, consult a tax practitioner before engaging in a transaction for fear of the tax consequences, and obtain professional assistance in preparing a tax return. For still others, complexity means uncertainty of statutory language.

While complexity of the tax laws is a serious problem, it is clear that trade-offs are necessary to achieve a significant degree of simplification. The issue of trade-offs arises whenever simplification conflicts with another objective sought to be achieved through the tax laws. The principal conflicting objectives are described in the following discussion of the reasons for complexity of the tax laws.

2. Reasons for complexity of the tax laws

Although there are numerous factors contributing to tax complexity, the most significant factors relate to the adoption of tax policies to achieve greater equity and to promote various economic and social objectives. The most important equity consideration which may contribute to complexity concerns the principle that similarly situated individuals should bear similar tax burdens (horizontal equity) and that differences in ability to pay among individuals be taken into account where necessary and appropriate (vertical equity).

Equity objectives are important factors underlying both the graduated rate schedules and the separate rate schedules for taxpayers who are single, married, or unmarried heads of households. Equity objectives are also a major consideration underlying certain exclusions, deductions, exemptions, or credits provided under the tax laws. Most of these provisions add some complexity to the tax laws.

Tax incentives are provided for the attainment of numerous social and economic purposes. These incentives include provisions relating to economic growth and stability, assistance to State and local governments, promotion of home ownership, charitable giving, and participation in the political process. Most of these provisions add complexity to the tax laws.

There are additional reasons for complexity in the tax laws. These include the necessity for compromise in formulating tax policy, the time and revenue constraints sometimes applicable in the development of legislation, and the tendency to "fine-tune" or to carefully draw legislation to limit an incentive to a particular situation (or to make the provision administratively feasible or to prevent tax avoidance or evasion). The imposition of special provisions to limit indirectly the use of incentives also contributes to complexity, e.g., recapture rules and the minimum tax provisions. There are also situations where tax provisions need to be complex to adequately deal with complex business transactions. In addition, revenue loss considerations may often necessitate the use of transition rules which complicate the law. The judicial review system can contribute to complexity because the various courts having trial and appellate jurisdiction over Federal tax matters may give conflicting interpretations of the law. Finally, to the extent uncertainty is viewed as a form of complexity, the objective of providing certainty may lead to complexity in the form of elaborately detailed statutes designed to prescribe necessary qualifications and limitations.

3. Base-broadening and tax simplification

Generally, proposals to broaden the income tax base are primarily based on considerations of equity and efficiency rather than on simplification. Usually, the arguments for a comprehensive tax base are made on the basis of horizontal equity, i.e., equal treatment of equal economic income without regard to the source of income. In some ways broad-based inclusion of income would contribute toward simplification in the administration and interpretation of the law, but not in others. The principal kind of simplification resulting from comprehensive base-broadening would be the elimination of exclusions and special deductions. The benefits of this kind of simplification would accrue to administrators, the courts, and practitioners. As for taxpayers, comprehensive base-broadening would contribute toward simplification for some and toward complexity for others. For example, the elimination of income source distinctions might contribute to simplification for a taxpayer who will have to file a return in any event because the return and instructions could be simplified. However, the inclusion of government transfer payments, such as welfare payments, under a comprehensive tax base would contribute to complexity for a taxpayer who, but for the broad inclusion rule, would not be required to file a return. Furthermore, additional complexity might result in valuing non-cash items includible in income under a comprehensive tax base.

Comprehensive base-broadening might have an indirect effect on simplification. The adoption of a comprehensive tax base could have a favorable indirect effect on simplification if tax rates were significantly reduced. The reduced rates would tend to reduce pressures for high-income taxpayers to engage in transactions the principal purpose of which is to reduce taxes, such as shelter deals. To this extent, the need to prescribe complex provisions to deal with tax avoidance and abuse of tax incentives may be reduced.

The principal features of proposals for a comprehensive tax base that could have a substantial impact on simplifying the tax law include the elimination of special treatment for certain types of income and the elimination or reduction of itemized deductions. However, elimination of some or all of these provisions might frustrate the attainment of objectives which the provisions were designed to achieve unless alternatives were provided. The Congress could review these provisions to determine if their purposes are still considered meritorious and, if they are, whether current law is the most efficient method of achieving those objectives and whether any modifications could be made to reduce complexity.

In terms of simplification, the most significant provisions are those relating to the treatment of capital gains. Generally, it is recognized that the treatment of capital gains results in a significant amount of tax complexity. However, any consideration of the elimination of special tax treatment of capital gains would necessitate the consideration of a number of related issues. Some of the most significant issues concern the possible effects on capital formation, e.g., the effect on investment, savings, and risk-taking. These issues would also include a consideration of the effect upon the mobility of capital, i.e., increased taxes on realized gains could adversely affect the "lock-in" problem to the extent there is a greater incentive to hold assets to avoid taxes imposed upon the realization of a gain. Another important consideration would be the effect of inflation on the measurement of gain. An additional consideration would be the problem of the imposition of a graduated tax rate on realized gains which are bunched into one year even though the gains have accrued over a number of years. In addition, some limitation on the deductibility of losses may have to be retained, in order to prevent tax-loss selling from completely off-setting liability for tax on other income.

Solutions to these problems could reintroduce complexities into the tax law even if the special tax treatment for capital gains were repealed. For example, if limitations continue to be imposed on the deductibility of losses incurred on the disposition of a capital asset, it would be necessary to retain the definition of a capital asset or to provide one for property to which the loss limitation applied. To some extent, however, definitional complexity could be reduced if the limitation applied to losses incurred with respect to a more easily identifiable or defined class of property, such as marketable securities. Similarly, the addition of special averaging rules for gain from the disposition of property held for a long term would perpetuate many of the current definitional problems, unless they could be mitigated by generally extending the availability of the special averaging mechanism to all long-term gain, other than that which arises from the disposition of inventory and similar property. Moreover, a new source of complexity would be introduced if a basis adjustment (or any other indexing method) were permitted in recognition of the effect of inflation on the measurement of gain.

Although principally related to equity considerations of tax reform, other base-broadening items that could be considered as having some relationship to simplification for some groups include (1) elimination of the exclusion for interest received on State and local obligations, (2) elimination of the dividends received exclusion, (3) full inclusion of military benefits and allowances, (4) full inclusion of foreign source earnings, (5) inclusion of all premiums paid by an employer for group term life insurance, (6) elimination of the exclusion for employer-financed health insurance, (7) inclusion of all sick pay, (8) inclusion of workmen's compensation, (9) inclusion of all scholarships and fellowships, (10) elimination of many of the tax-free exchange rules (e.g., reinvestment in residence, reinvestment in property involuntarily converted, and certain transfers to controlled corporations), and (11) the provision of more definitive rules for the inclusion of miscellaneous employee fringe benefits (e.g., employee discounts, parking facilities, company car).

In the case of businesses, base-broadening proposals that have some relationship to simplification include (1) elimination of the exclusion for interest received on State and local obligations, (2) elimination of deferral on foreign source income and repeal of the so-called "subpart F" provisions, (3) repeal of the Domestic International Sales Corporation ("DISC") provisions, (4) elimination of percentage depletion and accelerated depreciation provisions, (5) provision of more definitive rules to determine deductible amounts attributable to expenses having both personal and business purposes or elimination of deductions for entertainment, and social or recreational club dues, (6) the elimination or substantial restriction of the availability of tax-exempt status for organizations, (7) elimination of excess bad debt deductions for financial institutions, and (8) elimination of many of the tax-free exchange rules.

These provisions could be reviewed by the Congress to determine if the simplification benefits obtainable by repeal or significant revision outweigh the objectives underlying their present treatment.

The evaluation could also include appraising the relative benefits and detriments in instances where changes simplify the law for one group (e.g., tax administrators) but complicate it for others(e.g., taxpayers). Moreover, the Congress could evaluate whether a tax incentive approach or some alternative method is the most efficient method of achieving intended goals. In addition, the Congress could determine the extent to which rates could be reduced because of revenue gains from any changes.

If base-broadening itself rather than simplification is the principal objective, a review of base-broadening proposals would also include the income tax treatment of (1) government transfer payments (including public assistance, veterans' benefits, unemployment insurance, social security, and railroad retirement benefits), (2) gifts and inheritances, (3) contributions and earnings under qualified retirement plans during an employee's working career, (4) life insurance proceeds, and (5) unrealized appreciation.

Base-broadening can also include the elimination of itemized deductions. However, there are several alternative methods of reducing the use of itemized deductions which would not be considered within the scope of base-broadening proposals, e.g., the substitution of credits for itemized deductions.

4. Itemized deductions and simplification

There are several possible ways to reduce the number of taxpayers who claim itemized deductions. For instance, the standard deduction (now referred to as the "zero bracket amount") could be increased so that more taxpayers would switch from itemizing deductions to claiming the standard deduction. However, many taxpayers who do not actually claim itemized deductions would still have to compute their itemized deductions to determine if itemizing were advantageous. Revenue constraints would prevent raising the standard deduction to a level at which almost all taxpayers would not have to determine whether itemizing is advantageous.

Alternatively, the extent of itemizing could be reduced by converting deductions into credits. However, this approach merely shifts the complexities from a problem concerning itemized deductions to a problem concerning credits against tax. Moreover, the complexities would then affect a greater number of taxpayers, since credits would be available to taxpayers who do not itemize deductions. Similar problems would arise from changing deductions from itemized deductions to deductions in computing adjusted gross income which may be claimed by taxpayers who elect the standard deduction.

Another method would be to selectively repeal or restrict some of the itemized deductions. For example, repeal of the deductions for home mortgage interest and property taxes would cause a significant shift in taxpayers to the standard deduction. However, repeal of these provisions could have an adverse impact on home ownership, the demand for housing, and the economic health of the construction industry and certain financial institutions. These consequences could be avoided only if some alternative subsidy were provided. If repeal of the deductions were phased out over a transitional period to minimize economic disruption, there would be increased complexity for the short-run.

Restricting itemized deductions by adding new limitations and qualification requirements could similarly complicate rather than simplify the law. However, simplification would be achieved for taxpayers who can readily determine that itemizing is not beneficial because of new limitations and qualification requirements. The Congress might be able to minimize some of the economic effects of elimination or curtailment of itemized deductions by revising only a few deductions at a time and by providing generous transitional rules. However, such an approach might not generate sufficient revenue in the early years to support a significant across-the-board rate reduction (which many people think is an essential condition for reduction of itemized deductions).

If some or all itemized deductions were to be curtailed, the disposition of the revenue gain must be considered. Some argue that it is equitable to return this revenue gain to the class of persons who itemize deductions. Others believe that the revenue should be available to both current itemizers and nonitemizers by way of general rate reductions. Still others believe that the revenue should be retained by the government (e.g., to reduce deficits), rather than returned to taxpayers through rate reductions.

5. *Illustrative base-broadening simplification options*

To illustrate the extent to which tax rates could be reduced if the tax base were broadened by reducing the exclusions from income and itemized deductions, the study presents four base-broadening options of varying comprehensiveness. These illustrative base-broadening options are discussed in detail in section VII. They range from Option A, a very minor broadening of the tax base which would permit a reduction in tax rates of only one percentage point in each bracket rate, through Option D, which would eliminate virtually all itemized deductions and include in the tax base virtually all tax-exempt income. This comprehensive base-broadening would permit an overall reduction in tax rates of nearly 60 percent. reducing the rates from the current 14 to 70 percent range to a range of 8 to 35 percent. Between these two options are two other illustrative options. Option C eliminates most itemized deductions and most of the exclusions from income reported on the tax return but does not include presently tax-exempt sources of income, such as interest on State and local bonds and social security income as does option D. This base-broadening option would permit a reduction of tax rates to a range of 11 to 50 percent. Option B is presented as an intermediate step between Options A and C, and would permit a range of tax rates from 12 to 60 percent.

These base-broadening options are intended to be only illustrative of the degree of rate reduction associated with various levels of base-broadening. They are not intended as recommendations and do not represent the views of the Joint Committee or its staff as to what is desirable.

B. General Suggestions

1. Review of present law

It is suggested that there be a periodic review of special tax provisions to see if their beneficial effects warrant the degree of complexity added to the tax system. Section V of the report describes some of the issues regarding simplification of the individual income tax. As a possible starting point of a review of present law for simplification purposes, some or all of the issues described in that section could be selected by the tax-writing committees for review.

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It is suggested that the Ways and Means Committee and Finance Committee require staff analysis of any possible complicating effects of each tax proposal considered by the committees.

It is also suggested that the committees receive data and testimony concerning the possible effects of a proposal on tax complexity from the staff of the Treasury Department and the public. This data could include an estimate of additional paperwork which would result from the proposal and the compliance costs. In addition, it is suggested that the effect of a proposal on the tax forms be considered, whenever feasible, by the tax-writing committees. This could be done in certain cases by having the Internal Revenue Service, in consultation with tax policy officials of the Treasury Department, prepare sample tax forms which reflect the proposal.

II. GENERAL DISCUSSION OF TAX SIMPLIFICATION

A. Introduction

While there may seem to be a growing awareness of the need for simplifying the law, the concept of tax simplification often appears to be more accepted in theory than in practice. This is attributable, in part, to the different meanings assigned to simplification by various groups, and in part to the fact that the concept of simplicity frequently may conflict with inherent structural complexities of an income tax and with objectives considered to be more important, e.g., equity and the achievement of certain social or economic goals. Thus, simplification may become a secondary concern in the presence of a more important competing objective. The relative importance of simplification depends upon the context in which it is placed. In terms of impact upon our voluntary self-assessment system, the need for simplification may be less urgent in those contexts which do not affect the majority of taxpayers. Yet, in all cases, the issue of tax simplification involves record-keeping requirements and forms. It affects the ease of taxpayer compliance, and the ease of governmental administration. It deals with certainty, and with the ability to obtain an answer and to know thereafter what consequences reasonably will result from that determination.

Simplification, therefore, cannot be considered as an isolated issue, since its desirability depends on the perspective from which it is viewed. However, regardless of perspective, tax simplification is important because of the adverse impact complexity may have on the integrity of our voluntary self-assessment system.

The provisions of the tax laws which provide different treatment for certain types of income or expenses not only directly benefit certain taxpayers by lowering their tax liability, but also, in many situations, confer indirect benefits on industries in which demand is stimulated by the favorable tax treatment. It is to be expected that groups directly or indirectly benefited by a special tax provision would be likely to object to its repeal or contraction, even if they support the concept of simplification.[1] This is evidenced by a recent study by the

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[1] For example, see Nolan, *A New Tax Structure for the United States—Problems of Implementation and the Impact of the Political Process*, speech delivered March 30, 1977, as part of the University of Michigan Key Issues Lecture Series.

In his speech, Mr. Nolan observed:

"What are the real prospects for such major structural changes in the income tax? One thing is clear—the political process in the U.S. today is *extraordinarily* sensitive to various major groups, particularly where the tax system is concerned. These include such diverse classes as business, labor, the investment community, the real estate industry, the life insurance industry, the aged, the minorities, state and local governments, charities, the churches, the educational institutions and teachers and educators, and others. Each has major vested interests in the existing system which they will not give up without a bitter fight, each wanting a simpler, more equitable, and more efficient system, with lower rates for everyone, *but always with their particular vested interests fully preserved.*" Id., at 12 (emphasis in original).

Roper Organization, Inc.,[2] which concludes that many Americans consider the income tax system unfair in part because of special provisions. However, the study indicates that their belief appears to be based on a misunderstanding of how the tax system works, and, although individual taxpayers generally want reform and simplification, they do not want it at the expense of losing deductions and credits which affect them. In addition, the study found that the public favored the general concept of base-broadening with lower rates. However, when specific base-broadening examples were presented, the public rejected them and favored the present system.

B. Meanings of Tax Simplification

Tax simplification means different things to different people depending upon the context in which the term is used and upon the user's particular concerns.

1. For individual taxpayers

For the majority of individual taxpayers, simplification of the income tax laws means eliminating difficulties encountered in understanding the filing requirements or completing the return and understanding the instructions to the form. For many, the consequence of a lack of confidence in comprehending the law and forms is that professional assistance must be secured for the preparation of his return. The fact that a cost is incurred for tax return preparation increases taxpayer frustration over complexity of the tax laws. Complexity is evidenced by the frequency with which taxpayers request advice concerning less complicated provisions through the taxpayer assistance program of the Internal Revenue Service.

The scope of these problems is evidenced by the fact that approximately one-half of the individual taxpayers employ third parties to prepare their income tax returns. In addition, a substantial number of inquiries are made each year to the taxpayer assistance service of the IRS. Moreover, it has been suggested that an individual must read at the level of a college graduate in order to cope, unassisted, with the instructions for the individual income tax forms for dividend and interest income and itemized deductions.[3] In a recent speech, the Commissioner of Internal Revenue stated that statistical evidence had been received from the Department of Health, Education, and Welfare that the basic filing requirements were beyond the comprehension of a large portion of the adult population.[4]

2. For the tax practitioner

For the tax practitioner, the emphasis on the need for simplification may be different from that of the average taxpayer.

A paramount concern of practitioners is the need for certainty. For many, uncertainty is synonymous with complexity. This is attributable largely to the fact that a good part of the practitioner's time is devoted

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[2] Roper Organization, Inc., The American Public and the Income Tax System (1977) (commissioned by H&R Block, Inc.)

[3] Hearings on H.R. 7590, before a Subcommittee of the Committee on Government Operations, 92d Cong., 2d Sess., 251 (1972) (statement of William J. Emerson).

[4] Address by IRS Commissioner Jerome Kurtz, Eleventh General Assembly of the Inter-American Center of Tax Administrators, May 9, 1977 *reprinted in*, 123 Cong. Rec. S. 8349 (May 23, 1977).

to counselling clients and to keeping abreast of developments in the law.

Uncertainty affects practitioners in several ways in advising clients. In many instances, a reasonably certain conclusion as to the tax consequences of the client's problem cannot be determined, notwithstanding diligent and expert research. Moreover, in certain situations, it is neither feasible nor appropriate to resolve doubts by requesting a ruling from the Internal Revenue Service. Nevertheless, it is the professional's responsibility to formulate a reasoned judgment as to the applicability of the law and, regardless of the amount of information supplied to the client, it is the practitioner's judgment that, in most instances, will guide and mold the ultimate decision.

3. *For legislators and other policymakers*

For legislators and other policymakers, tax simplification has an especially important, yet varied, function. Since they are the originators of the revenue laws, legislators must attempt to design a tax system which effectively and efficiently raises revenue but recognizes other competing objectives. Simultaneously, considerations of tax equity and simplicity must be reconciled. This task is not accomplished easily.

4. *For the tax administrator*

For tax administrators, the emphasis of simplication concerns procedural as well as substantive aspects.[5] More particularly, for the administrator, simplification focuses on the management of the tax system, through Treasury Regulations, Internal Revenue Service rulings, taxpayer assistance, and on the processing and auditing of tax returns together with the resolution of conflicts and the supervision of taxpayer compliance.[6] The successful implementation of these functions and responsibilities depends both on the clarity of the law and on the availability of resources devoted to its supervision. Thus, institutional constraints, as well as statutory ambiguities, may inhibit the administrator's role in the simplification process. Among the institutional constraints are manpower and time limitations, the size of the supervisory staff, and the volume of returns filed. Implicit in these restrictions are the problems of statutory clarity and interpretation, effective dates of legislation, and taxpayer compliance, including the difficulties engendered by the relative inability to detect a questionable reporting position taken on a return. These problems, in turn, compound the complexity faced both by the Service and by taxpayers.

5. *For the courts*

Normally, the courts act as arbitrators of tax liability disputes between taxpayers and the government. This process necessitates (1) a determination of the pertinent facts; (2) a determination of the appropriate rule of law; and, (3) a finding and explanation of why

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[5] *See* Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L & Contempt. Prob. 676 (1969).

[6] L. H. Wright, et al., Comparative Conflict Resolution Procedures in Taxation (1968); *see also*, Report on Administrative Procedures of the Internal Revenue Service, October 1975, to the Administrative Conference of the United States (1976), *printed as*, S. Doc. No. 94–266, 94th Cong., 2d Sess. (1976).

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the facts fulfill or fail to fulfill the prerequisites for liability under the applicable law.

The probability of complexity increases if courts are faced with applying statutes that are vague or complex or if adequate statutory guidance is not provided.

Thus, for the courts, tax simplification concerns ability to understand and apply the statute with a reasonable degree of certainty and uniformity. For the courts, however, the emphasis on these attributes of simplicity is especially important because a decision by a court may have far-reaching precedential consequences affecting a large number of taxpayers.

C. Possible Conflicts Between Simplification and Other Goals

1. In general

Although governments long have sought to implement simplified revenue-raising systems, a perfect synthesis of equity and simplicity has rarely, if ever, been achieved. Nevertheless, the goal remains worth striving for and a fairly assessed and administered income tax may be the least objectionable way of raising revenue.

A number of standards have been proposed as guides for policymakers seeking to structure a fair and equitable revenue-raising system. Perhaps the most noted of these are Adam Smith's maxims of taxation. According to Smith, taxes should be *equitable*, with each person contributing according to ability; *certain*, that is, "clear and plain to contributor and every other person"; *convenient* as to time of imposition and payment; and *economical*, that is, inexpensive to collect, and not unnecessarily demoralizing to taxpayers. Inherent in these standards are the supplemental requirements of administrability and adequacy of revenues.[7] Notably, each standard expressly or implicitly affects the concept of simplification. Yet the standards should not be read as emphasizing simplicity as the dominant objective.

When equally important principles of taxation appear to require divergent approaches, these conflicts must be resolved. Often, the reconciliation of competing principles or objectives results in the introduction of complexity and intricate detail into the tax system. So long as the resulting compromise preserves, to the maximum extent possible, the substance of tax law goals, the encroachment on simplicity may well be acceptable. The crux of the issue, then, is the degree of complication acceptable in exchange for the increased realization of other valued goals.

Moreover, the inherent structure of our income tax makes a certain level of complexity unavoidable. Thus, many of the complexities of the income tax law are attributable to the nature of the income tax itself which is imposed *annually* on the *net income* of specified *taxable units* at *graduated rates*. The tax statute must elaborate on each of these fundamental aspects of taxability, inevitably giving rise to definitional problems. Initially, it must be determined whether an item constitutes "income" which is subject to the tax, or whether it constitutes a nontaxable receipt, such as a recovery of capital. In arriving at the tax base, any applicable *deductions* or *exclusions* must be taken into account thereby reducing the *gross* amount to *net income* to which the tax

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[7] A. Smith, An Inquiry Into The Nature And Cause Of The Wealth Of Nations, bk. 5, ch. 2, pt. 2. For a more complete description of standards by which a revenue system could be evaluated, *see* R. Goode, The Individual Income Tax 12–32 (1976 rev. ed.); R. Musgrave, The Theory Of Public Finance (1959); R. Musgrave & A. Peacock (eds.), Classics In The Theory Of Public Finance (1958); Jacoby, *Guidelines Of Income Tax Reform For The 1960's, in* Panel Discussions before the Comm. on Ways and Means, 86th Cong., 1st Sess., 1 Tax Revision Compendium 157 (Comm. Print 1959), hereinafter cited as Tax Revision Compendium.

rate applies. Further complexities arise as to each of these determinations because necessary timing rules must be provided to implement the assessment of the tax on an annual basis. These rules relate to the concept of "realization" for purposes of determining *when* income is taxable and to the payment or accrual of expenses for purposes of determining when deductions are taken into account. Also, they relate to the concept of "recognition" for purposes of determining *when* (or whether) realized income is to be taken into account for tax purposes. These rules must deal with an almost unlimited range of factual circumstances, e.g., the single question of realization of income by so-called "constructive" receipt may arise in a variety of contexts. In addition, certain complexities are unavoidable in providing necessary rules for the identification of the proper taxpayer, that is, the person who must include an income item and who may take a deduction. Frequently, selecting the proper taxpayer from among the potentially taxable units calls for making sharp distinctions which add complexity to the law.

For business taxpayers, complexity in tax reporting may be increased by differences in the accounting information required for financial reporting purposes and for tax purposes. Further complexity is caused by differences in the treatment of some items for financial reporting and tax purposes.

Another complicating aspect for many businesses involves the accrual method of accounting. It may be argued that the cash method of accounting for tax purposes is less complex than the accrual method. However, the accrual method of accounting is often necessary to clearly reflect income.

With the preceding discussion of the basic maxims by which a tax system may be evaluated and the inherent complexities of an income tax as background, this portion of the report deals with the possible conflicts between simplification and other goals.[8]

2. Tax equity and simplification

In many instances, fairness may require a certain amount of complexity. There are two equity principles generally associated with tax laws, i.e., "vertical equity," pursuant to which persons with larger incomes pay greater amounts of tax, and "horizontal equity," pursuant to which persons with substantially the same amount of income pay the same or approximately equivalent amounts of tax.

a. Vertical equity

One of the most acute problems inherent in achieving an equitable scheme of taxation, and certainly a major contributor to complexity, is the desire to differentiate among taxpayers according to their respective abilities to pay.[9] This principle of vertical equity relates to the

[8] Many of the issues set forth in this discussion were also raised by participants in a panel discussion on simplifying and restructuring the tax law before the Committee on Ways and Means on June 24, 1975. *Panel Discussions on the Subject of Tax Reform, Before the Committee on Ways and Means*, 94th Cong., 1st Sess. 125–394 (June 24, 1975).

[9] For a detailed analysis of this concept, *see* R. Musgrave, *supra*, ch. 1–5. The January 17, 1977 Treasury study, "Blueprints For Basic Tax Reform" noted that ". . . although the Federal tax system by and large relates tax burdens to individual ability to pay, the tax code does not reflect any consistent philosophy about the objectives of the system."

ability-to-pay principle that individuals with larger incomes should pay a greater amount of tax, both in absolute terms and as a percentage of total income, than do individuals with lesser amounts of income.

The ability-to-pay principle also forms the basis for several provisions that add complexity to the law. The graduated rate schedules are a prime example of the principle. It is easily understood that a flat rate would be less complicated for taxpayers to compute. However, it is also clear that a flat-rate tax disregards the greater ability of high-income individuals to contribute to the cost of government.

Other provisions based primarily on ability-to-pay principles are the separate rate schedules for taxpayers who are single, married, or unmarried heads of households. While the actual use of one schedule instead of another may not affect the complexity of the tax calculation, the eligibility rules for a particular schedule may be difficult to understand and the fact that several rate schedules are printed in the tax return instructions may be confusing.

b. Horizontal equity

Legislative changes designed to achieve horizontal equity will sometimes simplify the law and sometimes complicate it. For example, if it is assumed that horizontal equity could be advanced by the repeal of the special capital gains provisions, repeal of those provisions would be consistent with both an equity objective and a simplification objective since these provisions add considerable complexity to the tax laws. Of course, this general conclusion leaves aside other arguments related to equity, e.g., that it is inequitable to fully tax inflation-induced gains on property held for a long period of time.

On the other hand, some of the provisions of present law for which arguments can be made on the basis of horizontal equity add to the complexity of the tax laws. One example of the attempt to achieve horizontal equity in the tax system is the complicated provision governing income averaging. In certain circumstances, this provision generally allows taxpayers to aggregate the total amount of income realized over several years and to pay the current year's tax on the average amount of that total.

The income averaging provisions were designed for taxpayers who have fluctuating incomes, and who, as a result of the combination of the graduated rate schedules and the annual accounting period, would pay a heavier tax on the fluctuating amount than on an equal amount of income spread evenly over the years involved. Averaging is considered to satisfy the prerequisites of horizontal equity and simultaneously is considered consistent with vertical equity objectives since the taxpayer's ability to pay is judged by the average annual amount of income over the averaging period. In general, a taxpayer who is eligible to average his income is taxed as if the income had been earned more evenly over the averaging period.

In part, the carryover basis provisions for inherited property were enacted by the Tax Reform Act of 1976 for tax equity reasons. Under prior law, the appreciation on property transferred from a decedent was not subject to income tax because the heir's basis in the property for determining gain was stepped-up to its value at the decedent's death. This was considered to be discrimination against those who sell their property prior to death as compared with those whose property was not sold until after death. In addition, it was thought that there was some discrimination between taxpayers who receive property by gift and those who inherit property since the donor's basis in property is generally carried over to the donee. While the carryover basis provisions may advance tax equity, they add complexity to the tax laws because, for example, it may be difficult to ascertain the decedent's basis in certain property, and a number of basis adjustments must be computed for death taxes attributable to appreciation (which are designed to mitigate the impact of having both income taxes and death taxes imposed on appreciation).

Various comprehensive base-broadening proposals supported by horizontal equity considerations would provide a type of simplification for some groups. For example, the inclusion of government transfer payments, such as unemployment compensation, in gross income might simplify the law for legislators and administrators in the sense that income source distinctions need not be made. In addition, broad inclusion rules would contribute toward simplification in administration and interpretation. Comprehensive base-broadening could be used as a vehicle for overall simplification. However, an all-inclusive rule for gross income might be viewed as contributing to complexity by the taxpayers affected. For example, taxpayers required to file returns solely because of the treatment of government transfer payments as taxable income would hardly consider base-broadening to be a simplication of the tax laws. Thus, certain comprehensive base-broadening proposals to achieve horizontal equity could be viewed as contributing to simplification for some and to complexity for others.

c. Coordination of treatment between taxpayers in common-law States and in community property States

Another source of complexity in the tax law arises out of the attempt to coordinate the tax treatment of individuals in common law and in community property States. Because of the basic conceptual and technical differences between property laws, special rules have been devised to provide similar Federal tax treatment of individuals under the two systems. Under the income tax laws, the joint return rules have been adopted in response to the differences in State property laws. Special rules also are necessary under the estate and gift tax laws to provide greater similarity of tax treatment between residents of common-law States and residents of community property States.

While none of these rules individually are more complex than other provisions of the tax law, their intricacy and detail are compounded when they are integrated with the more generally applicable tax rules. The very existence of two separate sets of rules also tends to complicate the tax structure and to confuse taxpayers who move from one type of jurisdiction to the other. In certain cases, simplification has been achieved simply by disregarding the community property laws for tax purposes. An example of this is the rule for individual retirement accounts that contribution limitations and other rules are to be determined without regard to community property laws (sec. 408 (g)).

3. *Simplification and social or economic incentives under the tax laws*

Another obstacle to tax simplification results from the use of the tax system to achieve social or economic goals. Essentially the goals sought to be accomplished are directed to ends other than revenue raising. They are embodied in a variety of measures designed either to promote or to discourage particular actions. The costs attributable to these incentive provisions are commonly referred to as "tax expenditure" costs.

Since the income tax system can be used without establishing new agencies and tax considerations may significantly affect the decision of whether to act in a specified manner, the Congress, frequently on the recommendation of an agency or department, has periodically sought to accomplish a variety of social and economic objectives through the tax laws. These objectives include, for example, capital formation, economic stimulation, philanthropy, and the preservation of historic structures.

The most recent publication on Federal tax expenditures [10] lists thirteen categories of tax expenditures determined on the basis of functional categories as reflected in the Federal budget. These functional categories are:

(1) National defense;
(2) International affairs;
(3) Natural resources, environment, and energy;
(4) Agriculture;
(5) Commerce and transportation;
(6) Community and regional development;
(7) Education, training, employment, and social services;
(8) Health;
(9) Income security;
(10) Veterans benefits and services;
(11) General government;
(12) Revenue sharing and general purpose fiscal assistance; and
(13) Interest.

Included within these functional categories are eighty-six separately listed items. The scope and number of the tax expenditures contribute significantly to complexity of the tax laws.

These socio-economic provisions of the tax code include special deductions, credits, or exclusions applicable only to a specific action. In some instances, these provisions may be combined with preferential timing rules. Targeting refinements contribute to the complexity of the tax laws by adding what some consider "excessive" statutory detail.[11]

What has been considered as overuse of tax incentives has led to the adoption of additional complex mechanisms to cut back indirectly on the benefits available to any particular taxpayer. These provisions include the minimum tax imposed on tax preferences, preference offsets for the maximum tax on earned income, various recapture rules, and the "at risk" rules. These provisions add complexity to the tax laws.

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[10] Staff of the Joint Comm. on Taxation, Estimates of Federal Tax Expenditures, 95th Cong., 1st Sess. (1977).

[11] For example, see Bittker, *Tax Reform and Tax Simplification*, 29 U. Miami L. Rev. 1, 10. (1974).

4. Provisions designed to cover complex transactions

In formulating tax rules for complex business transactions, it is often necessary to adopt complex provisions. However, complexity of intricate arrangements devised by taxpayers to minimize, or to eliminate, taxes is not so urgent a concern as is tax complexity at a more generally applicable level.[12] Moreover, some transactions are inherently complex, even in the absence of any tax considerations, and, therefore, probably require the formulation of comprehensive statutes if they are to be brought within the purview of the tax law.[13] For example, it is difficult to conceive of simple tax statutes to deal adequately with problems of triangular reorganizations, commodity straddles, retirement plan qualifications, trust transfers, or corporate distributions, redemptions, and liquidations. Easily discernible tax consequences, or fact patterns, are not the usual characteristics of these transactions. The problem is the need for sufficiently detailed, but broadly applicable statutes that can be applied effectively in complex cases.

It is often necessary to reach some kind of balance between a generalized and a detailed statutory approach. A generalized provision may increase the uncertainty of the tax consequences of complex transactions. On the other hand, a detailed provision dealing with complex transactions may also be very complicated.

In addition, precisely drawn and elaborately detailed statutes may inadvertently increase the odds of winning the "tax lottery", or chance that a questionable position may not be challenged on audit, by failing to cover a novel or unanticipated situation which logically should be within the scope of the statute.[14]

While improving statutory language by eliminating technical phrases and replacing them with clear and simple terms certainly is a goal to be sought, "[t]his is easier to promise than to deliver . . ."[15] especially where the language involved has a technical meaning not easily translatable into simple terms.

5. Provisions to prevent tax avoidance

Rules dealing with tax evasion or avoidance also contribute to complexity. A number of the provisions under subtitle F of the Internal Revenue Code, relating to procedure and administration, are designed to deal with tax avoidance or evasion. For example, rules are

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[12] *See* Surrey, *Complexity And The Internal Revenue Code: The Problem Of The Management Of Tax Detail*, 34 L. & Contemp. Probs. 673, 697 (1969).

[13] *See, e.g.*, Lowe, *Bailouts: Their Role In Corporate Planning*, 30 Tax L. Rev. 357, 367 (1975); *cf.* N.Y. State Bar Association, Committee on Tax Policy, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 341, 348, 361 (1972).

[14] *See* Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 L. & Contemp. Prob. 698–699 (1969); Blum, *Simplification Of The Federal Income Tax Law*, 10 Tax L. Rev. 239, 246–248 (1955); N.Y. St. Bar. Assoc. Rep. *supra*, at 361

See also, *Chamberlain v. Comm'r.*, 207 F. 2d 462 (6th Cir. 1953), where the appellate court allowed capital gains treatment on a preferred stock bailout. The court noted that the transaction, which admittedly was designed to avoid taxation at ordinary income rates, fell within a statutory gap, and therefore the claimed capital gains treatment was available. Congress reacted quickly and negatively to the *Chamberlain* decision by enacting what is now § 306 of the Internal Revenue Code. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 46 (1954).

[15] Paul *Simplification of Federal Tax Laws*, 20 Cornell L. Q. 286 (1944); *see also*, Blum, *supra*, at 243.

provided for the imposition of civil and criminal fraud penalties, jeopardy assessments, and transferee liability. In addition other substantive provisions have been added to deal with either specific tax avoidance [16] situations or the conversion of ordinary income into capital gains.

6. Concern for administrative feasibility

Concern for administrative feasibility may complicate the law, both as to procedural requirements imposed upon taxpayers and in regard to supervisory responsibilities imposed upon the Internal Revenue Service. Administrative rules may also affect third parties as well as taxpayers and the Service, *e.g.*, payors of dividends or interest and fiduciaries required to furnish information. Nevertheless, administration of the tax laws is an enormously important facet of an effective and equitable revenue system. Without appropriate administrative rules, inadequate revenue may be collected, due either to taxpayer noncompliance or to excessive administrative cost.[17] An essential aspect of the tax legislative process must be an evaluation of the administrative feasibility of the proposed provisions, including an analysis of the proposal's projected impact on taxpayers, on the Service's ability to implement it, and on its compatibility with other tax provisions.

Administrative rules may add to the complexity of the tax laws. In certain instances, structural changes could be made for simplification purposes, e.g., the two separate extended payment provisions for estate taxes attributable to a closely-held business (secs. 6166 and 6166A). However, the vast majority of these rules are essential for the effective administration of the law and could not be substantially simplified. Moreover, the average individual taxpayer rarely has to contend with the complexity of administrative rules other than the most basic requirements and the payment of tax. (However, it should be noted that even the average individual taxpayer is faced with many elections provided under the Code, even though he may not be aware of their existence. According to a guide to Federal tax elections published by the American Institute of Certified Public Accountants, there were approximately 360 possible elections available under the

[16] These provisions include rules relating to the deductibility of expenses attributable to activities not engaged in for profit (sec. 183), losses, expenses, and interest with respect to transactions between related taxpayers (sec. 267), the disallowance of deductions and credits attributable to acquisitions to evade or avoid income tax (sec. 269), the disallowance of certain entertainment and foreign travel expenses (sec. 274), the disallowance of indirect contributions to political parties (sec. 276), the disallowance of expenses attributable to a vacation home (sec. 280A), the treatment of preferred stock dividend bailouts (sec. 306), the treatment of collapsible corporations (sec. 341), the treatment of net operating loss carryovers of an acquired corporation (sec. 382), the allocation of income and deductions between related taxpayers (sec. 482), the treatment of unreasonable accumulations of income by corporations (sec. 531 et seq.), the treatment of personal holding companies (sec. 541 et seq.), the treatment of appreciated property transferred to a trust (sec. 644), the treatment of grantor trusts (sec 671 et seq.), and the treatment of gain from the sale of depreciable property between related taxpayers (sec. 1239).

[17] See Sneed, *The Criteria of Federal Income Tax Policy*, 17 Stan. L. Rev. 567 (1965); Kahn, *Compliance And Enforcement Problems, in* 2 Tax Revision Compendium 1467, 1473–1475.

Code at the end of 1972, many of which were not identified by the word election.)

7. Revenue loss considerations

In the legislative process, revenue loss considerations will sometimes dictate the choice of more complicated alternatives. In recent years, the overall limitations adopted under budget resolutions pursuant to the Congressional budget procedures have affected choices among alternative approaches for specific issues. In some cases, the result has been to target tax incentives more specifically to minimize the revenue loss. Also, the constraint of revenue losses has been a factor in considering phasein rules for new provisions and phaseouts of benefit eligibility for high income taxpayers.

D. Other Factors Contributing to Tax Complexity

1. The Treasury Department and the Internal Revenue Service

For the average individual, tax complexity relates primarily to the number and difficulty of tax forms, schedules, and instructions. In many respects, the complexity of a particular form and of its instructions merely reflects the statutory complexity which the Internal Revenue Service must incorporate in the forms and instructions. The Service does conduct a continuing review of forms and instructions. In addition, several other programs are useful in spotting problems attributable to form design or the instructions. These programs include the taxpayer service quality review program, the math error detection program, the unallowable items program, and the taxpayer compliance measurement program.

The Service must exercise discretion as to the frequency with which revisions of forms are made. Annual changes might increase confusion for taxpayers who prepare their own returns and who typically use a copy of the prior year's return as a guide in preparing the current year's return. Of course, changes in the form and instructions are unavoidable when the law is amended.

For tax practitioners and more sophisticated taxpayers, regulations and rulings also are relevant to complexity. The rulings program tends to provide additional certainty and generally has a beneficial impact upon complexity of the tax laws.

The regulations also furnish guidance to taxpayers, tax practitioners, and the courts. The interpretations provided in regulations decrease uncertainty and thereby contribute favorably to simplification. On the other hand, the regulations may be difficult to follow because they tend to provide detailed rules and illustrations. In many instances, the more complicated regulations reflect the complexity of a detailed statute or attempt to fill in the gaps of a generalized statute. Thus, the regulations are often thought of as contributing to simplification by providing certainty and detracting from it by addressing a multitude of possible situations.

2. Present judicial review system

Under present law, tax litigation may be commenced in the United States Tax Court, the United States district courts, or the United States Court of Claims. These various trial courts may render conflicting or inconsistent decisions. This contributes to complexity because it may be confusing as to which interpretation is correct.

Appeals from the Court of Claims are taken by certiorari to the Supreme Court. Appeals from the Tax Court and the district courts are taken to the Court of Appeals for the circuit in which the taxpayer resides. There are eleven circuit courts. Thus, conflicts between circuits occur and contribute to uncertainty. Generally, review of decisions of the circuit courts is available only by certiorari to the Supreme Court.

The Tax Court, more than other courts, is affected by the availability of alternative forums and by the existence of 11 different courts of appeals. Initially, the Tax Court established the practice of following its own rule of law even when the decision was reviewable by a court of appeals which had adopted a contrary rule. However, in *Jack E. Golsen*,[18] the Tax Court announced that it would follow the decision of a court of appeals when the taxpayer's appeal lies to that court. Conceivably, then, the Tax Court could be faced with applying 11 different rules in similar factual circumstances. Where a decision involves more than one taxpayer it may be appealable to more than one circuit, and hence lead to different results on appeal.

Apart from the effects of the Tax Court's *Golsen* rule, the Tax Court makes substantial efforts to provide, at the trial level, for uniformity of Federal tax law throughout the nation. Each opinion of a judge is reviewed by the Chief Judge of the Tax Court. If the Chief Judge concludes that an opinion may conflict with other opinions of the court, the Chief Judge may direct that the case can be reviewed by the entire court (sec. 7460 of the Code). Such court-reviewed decisions are, then, followed by all of the judges in their subsequent cases. Another method that is used by the Tax Court to make for greater uniformity nationwide is the practice of having each of the judges preside at calendars in several parts of the country. This avoids having the views of any one judge become the *de facto* interpretation of the law for any given region of the nation.

The Committee on Tax Policy of the Tax Section of the New York State Bar Association has endorsed giving primary jurisdiction in civil tax cases to the Tax Court.[19] In addition, that Tax Section endorsed the creation of a Court of Tax Appeals that would be given exclusive jurisdiction to review Tax Court decisions.[20] The principal reason given for giving primary jurisdiction to the Tax Court was to secure more uniformity in decisions. The change recommended for appellate review was made principally to eliminate the delay often occurring under the present system and to achieve more certainty resulting from decisional uniformity.

The complexity arising from the present judicial review system generally does not affect the average individual taxpayer. In fact, the Tax Court small claims procedure largely insulates the average individual taxpayer from all of these problems. Under the small claims procedure, the proceedings are informal and do not follow technical rules of evidence. Moreover, decisions from the small claims division cannot be appealed by the taxpayer or the Government (sec. 7463(b)).

3. *Dual jurisdiction by governmental agencies*

In certain instances, multiple jurisdiction by two or more governmental agencies contributes to complexity of the tax laws. A prime example involves qualified pension, profit-sharing, and stock bonus plans, and similar arrangements which are subject to regulations written jointly by the Treasury and the Department of Labor, and en-

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[18] 54 T.C. 742 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971).

[19] New York State Bar Assoc. Report, *supra*, 352.

[20] Report of the Tax Section, New York State Bar Association, to the Commission on Revision of the Federal Court Appellate System, in II Hearings, Second Phase 1348–1361 (1975).

forced by both agencies subject to rules of the Pension Benefit Guaranty Corporation.[21]

In other cases, tax rules involve certification or approval by an agency other than the Treasury Department. In other situations, the tax laws require coordination with these other agencies because terms are defined by reference to nontax laws. Examples of these provisions include the coordination of the Work Incentive Credit with the Department of Labor, the tax treatment of certain Merchant Marine ships acquired with capital construction funds with the Maritime Commission, and low-income housing tax provisions with the Department of Housing and Urban Development.

These provisions add to complexity because two distinct bodies of law have to be coordinated and complied with in order to qualify for tax benefits. In many cases, the dual jurisdiction also results in delay.

Many of the provisions which are treated as tax expenditure items designed to achieve nontax social or economic objectives present a special kind of complexity to those charged with the administration of the tax laws. This imposes a burden upon the allocation of available manpower resources by requiring the Service to coordinate efforts with other agencies, develop the applicable forms, prescribe the necessary interpretative rules, and make the necessary audit examinations of these items.

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[21] See sec. 401(a)(12), providing rules for merger or consolidation of plans (or transfers of plan assets); as added by the Employee Retirement Income Security Act of 1974.

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III. STATISTICAL INFORMATION RELATING TO TAX SIMPLIFICATION ISSUES

This section provides statistical information on the individual income tax. The first part describes some general trends in the use and importance of the individual income tax; the second part discusses characteristics and trends in the utilization of IRS Forms 1040 and 1040A; and the third part discusses various indicators of taxpayer difficulty with the individual income tax.

A. Trends in Federal Taxation and the Use of the Individual Income Tax

1. Role of individual income tax

Prior to World War II, Federal collections for all taxes imposed were a relatively modest part of the overall level of economic activity. In 1916, total Federal taxes were 1.1 percent of the Gross National Product. The financing of World War I caused Federal taxes to grow to 5.9 percent of GNP by 1920. Federal taxes declined as a fraction of GNP to 2.8 percent in 1925, before rising slightly to 3.4 percent in 1930 and to 4.6 percent in 1935. Since 1940, however, Federal taxes have been a much larger percentage of GNP: for example, 20.7 percent in 1945, 18.2 percent in 1960, and 19.4 percent in 1975. (See table 1.)

Just as the role of Federal taxes has changed since the inception of the individual income tax in 1913, so too has the importance of the individual income tax. Initially, the individual income tax was a minor source of Federal funds; in 1916, it provided 13.3 percent of all Federal taxes. By 1930, it rose to 37 percent, but declined to 16–18 percent between 1935 and 1940. Since 1945, however, the individual income tax has grown in importance as a source of Federal finance: in 1945 in represented 40.7 percent of all Federal tax collections, and has stayed at or above 40 percent since then.

This shift toward the individual income tax has also been a shift away from excise taxes, which represented 41.3 percent of all Federal tax collections in 1935, but only 5.9 percent in 1975, as well as a shift from the corporate income tax from 41.6 percent of Federal tax revenues in 1930 to 14.5 percent in 1975. (See table 1.)

The importance of the individual income tax can also be gauged by comparing the income tax to total personal income in the economy. The ratio of income tax to personal income is, in effect, the average effective tax rate on individual income. In 1916 this rate was only 0.2 percent; in 1945 it was 11.1 percent; and it has continued in the 10–12 percent range since the mid 1950's. (See table 1.)

Table 1.—Share of Federal Tax Collections by Type for Selected Fiscal Years 1916–75

Fiscal year	Individual income tax as percent of total receipts	Corporate income tax as percent of total receipts	Employment (payroll) tax as percent of total receipts	Estate and gift tax as percent of total receipts	Excise taxes as percent of total receipts	Other taxes as percent of total receipts	Total tax collections as percent of GNP	Individual income tax as percent of personal income
1975	43.6	14.5	30.8	1.6	5.9	3.7	18.5	9.8
1970	46.7	16.9	23.4	1.9	8.1	2.8	19.7	11.3
1965	41.8	21.8	19.1	2.3	12.5	2.6	17.0	9.1
1960	44.0	23.2	15.9	1.7	12.6	2.5	18.3	10.2
1955	43.9	27.3	12.0	1.4	13.9	1.4	16.4	9.3
1950	39.9	26.5	11.1	1.8	19.1	1.7	13.8	7.0
1945	40.7	36.2	7.6	1.4	13.0	1.1	21.3	10.8
1940	17.5	15.4	27.0	5.5	29.0	5.7	6.3	1.4
1935	16.0	17.5	------	6.4	41.3	18.8	4.6	.9
1930	37.7	41.6	------	2.1	18.6	5.0	3.4	1.5
1925	32.7	35.5	------	4.2	20.8	6.8	2.8	1.1
1920	NA	NA	------	1.9	14.9	------	5.9	NA
1916	13.3	11.1	------	------	66.3	9.3	1.1	.2

NOTE.—NA: Not available.

Source: 1940–75, OMB, *Federal Government Finances.* 1916–35, U.S. Department of Commerce, *Historical Statistics of the United States.*

2. Number of tax returns filed

As the country has grown in population, so too have the number of individual income returns filed. Prior to World War II, the individual income tax was not widely applicable. In 1920, only 7.3 million returns were filed; this represented 12.6 percent of the prime age population and 17.6 percent of the labor force. By 1945, however, 49.9 million returns were filed, representing 60 percent of the prime age population and 93 percent of the labor force. Since 1945, the number of returns has kept pace with the size of the labor force, so that the number of returns filed since 1945 has been between 85 and 93 percent of the labor force. In 1975, 82.2 million returns were filed, representing 88.6 percent of the labor force.

Of related interest is the difference between the total number of returns filed and the number of returns filed which were taxable (i.e., had a tax liability.) Generally, as many as 25 to 30 percent of the returns filed have been nontaxable.

Table 2.—Individual Income Tax Returns in Relation to Population, 1915–75

Year	Total number of returns filed (millions)	Total number of taxable returns (millions)	Total returns as percentage of civilian labor force	Total returns as percentage of prime age population [1]	Taxable returns as percent of all returns
1975 [2]	82. 177	61. 753	88. 7	70. 5	75. 1
1970 [3]	74. 280	59. 317	89. 9	69. 0	79. 9
1965 [3]	67. 596	53. 701	90. 8	67. 9	79. 4
1960 [4]	61. 028	48. 061	87. 6	64. 6	78. 8
1955 [4]	58. 250	44. 689	89. 6	63. 7	76. 7
1950 [4]	53. 060	38. 186	85. 3	60. 2	72. 0
1945 [5]	49. 932	42. 650	92. 7	60. 0	85. 4
1940 [5]	14. 665	7. 504	26. 4	19. 0	51. 2
1935 [5]	4. 575	2. 110	8. 9	NA	46. 1
1930 [5]	3. 707	2. 037	7. 9	5. 6	55. 0
1925 [5]	4. 171	2. 501	9. 2	NA	60. 0
1920 [5]	7. 260	5. 518	17. 6	12. 6	76. 0
1915 [5]	. 337	NA	. 9	NA	NA

[1] Age 20–64.
[2] *Preliminary Statistics of Income: 1975.*
[3] From *Statistics of Income: 1971.*
[4] *Statistics of Income: 1962.*
[5] *Statistics of Income: 1941.*

NA=Not available.

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B. Trends in Characteristics and Utilization of the Individual Income Tax Form

Since the inception of the individual income tax in 1913, the tax form has gone through six general phases. During the first period 1913–17, the 1040 Form and instructions were a four-page form stapled together, with the instructions constituting one half a page and the 1040 Form the remainder. Page 1 contained general information (name, address, income, etc.); page 2 contained seven separate general deductions, and page 3 contained the jurat, i.e., signature and statement of belief as to correctness, etc.

During the second period, 1918–36, the 1040 Form was two pages and the instructions were two pages. Separate, alphabetically ordered schedules were on the second page of the 1040, and no additional attachments were required. During the third period, 1937 to 1960, the 1040 Form grew to four pages; however, since the two-page form during 1918–36 was on oversize paper, some of the growth in page length represented just a reformating. The instructions remained at two pages until 1945 when it grew to four pages. The fourth period covers 1948–1960. In 1948, the instructions grew to eight pages, and then to 12 pages in 1952, to 16 pages in 1954, and remained at 16 pages through 1960.

The fifth period covers 1961–63. During this period, the 1040 Form shrank to two pages, and the number of schedules on the 1040 declined to just itemized deductions and schedule A. It was during this period (1961–63) that the taxpayer was required to attach additional schedules, as needed, to the 1040 Form to document the claimed deductions, etc. Also during this period, the instructions grew to 19 pages.

The sixth period covers 1964 to the present. The 1040 Form has remained at two pages (except for 1969 when it shrank to one page) with no schedules whatsoever on the second page. Instead, various "parts" are provided to permit the taxpayer to enter totals arrived at from separate schedules which need to be attached. By 1975 the instructions had grown to 40 pages.

This historical overview indicates that the 1040 Form has constantly been changing, and that the long-term trend has been to make the basic 1040 Form shorter in terms of page numbers, but to require the taxpayer to affix additional information to the 1040 Form to substantiate his deductions, etc. There also has been a very clear trend in the size of the instructions: from one page in 1913 to 40 pages in 1976.

C. Indicators of Taxpayer Difficulty with the Income Tax

1. Use of tax return preparers

In recent years, concern has been expressed over the large number of taxpayers who utilize commercial tax return preparers to assist in filling out their individual income tax return. Table 3 shows the percentage of tax returns which were signed by a person other than the taxpayer. As indicated, only 18.2 percent of the tax returns in 1954 were prepared with outside assistance, while 48.3 percent of the returns were signed by a person other than the taxpayer in 1961 and 61.6 percent in 1974. For 1966, 1969, and 1974, the data on persons who used a tax return preparer are available by adjusted gross income. It is interesting to note that lower income groups relied quite heavily on tax return preparers. For example, in 1966, 55.7 percent of those with AGI under $2,500 used a tax return preparer, which rose to 61.3 percent in 1974. Also of interest is that higher income persons (those with AGI in excess of $50,000) used a tax return preparer more than 80 percent of the time.

Although significantly more than half of all taxpayers use the services of a tax return preparer (commercial return preparer, accountant, attorney, etc.), while only a small portion actually itemize, simplification may not necessarily alter this situation. To some extent, going to a tax return specialist is an efficient allocation of the taxpayer's time, for the specialist has already familiarized himself with the instructions (now over 40 pages), other IRS publications (such as "Your Federal Income Tax", which was 192 pages for 1976), and perhaps the regulations.

Table 3.—Taxpayer Use of Tax Return Preparers [1]

[In percent]

	1974 [2]	1969 [3]	1966 [4]	1961 [5]	1954 [6]
Total	61.6	52.9	55.7	48.3	18.2
AGI:					
Under $2,500	61.3	43.2	55.7		
$2,500 to $4,999	69.3	49.2			
$5,000 to $9,999	66.0	59.7	60.7		
$10,000 to $14,999	59.6	55.0		NA	NA
$15,000 to $19,999	59.3		47.0		
$20,000 to $29,999	54.8	55.0			
$30,000 to $49,999	65.3	71.0	68.7		
$50,000 and over	82.8	82.1	84.0		

[1] As indicated by signature of person other than taxpayer.

[2] U.S. Treasury Department, Internal Revenue Service, *Reporting Characteristics, Form 1040 Tax Year 1974* (June 1977), p. 18.

[3] U.S. Treasury Department, Internal Revenue Service, *Reporting Characteristics, Form 1040 Tax Year 1969* (August 1971), p. 17.

[4] U.S. Treasury Department, Internal Revenue Service, *Reporting Characteristics, Form 1040 Tax Year 1966* (October 1968), p. 11.

[5] U.S. Treasury Department, Internal Revenue Service, *Statistics of Income, Reporting Characteristics of Taxpayers for 1961*, p. 11.

[6] U.S. Treasury Department, Internal Revenue Service, *Reporting Characteristics of Taxpayers Filing Form 1040 for 1954* (May 1956), table 1.

2. Taxpayer error rates

Another indicator of taxpayer difficulty with the individual income tax is the extent to which errors are made in filling out tax forms. Table 4 shows the percentage of IRS 1040 and 1040A forms which contained mathematical errors. It should be noted that while the definition of a math error has generally involved errors in addition, subtraction, multiplication or division, the expanded use of data processing in the Internal Revenue Service in the early 1960's greatly enhanced the ability of the Service to check taxpayer arithmetic. On the other hand, beginning in the 1970's, the definition of a math error was narrowed by the Service in compliance with court decisions. With these caveats in mind, there still would appear to be a general upward trend in the percentage of returns with math errors. From 1953 to 1964, returns with math errors gradually rose from about 2.7 percent to about 4.0 percent. During the period 1965–68, error rates grew to just above 6 percent. Note that in 1970, it rose to 8.3 percent from 5.0 percent in 1969, perhaps reflecting taxpayer difficulty with the many changes made in the Tax Reform Act of 1969. Also, in 1976, the error rate rose to 8.8 percent from 4.7 percent in 1975, possibly due to the new general tax credit, the earned income credit, and the changes in the tax tables.

Table 4.—Percentage of IRS Form 1040 and 1040A's with Math Errors

Fiscal year	*Percent error*	*Fiscal year*	*Percent error*
1976	8.8	1964	4.1
1975	4.7	1963	4.2
1974	6.0	1962	4.3
1973	5.9	1961	4.2
1972	5.2	1960	4.0
1971	6.3	1959	3.4
1970	8.3	1958	3.3
1969	5.0	1957	3.1
1968	6.7	1956	2.7
1967	6.0	1955	2.3
1966	5.8	1954	2.7
1965	6.2	1953	3.2

Source: Annual Reports of the Commissioner of the Internal Revenue Service.

Recently, the IRS has tabulated the kinds of math errors that are detected when processing returns. Table 5 gives the results of math errors detected for processing year 1977 (tax year 1976) as of June 1977. Almost 11 percent of those who used the earned income credit made an error in computing it: 14 percent of those who used the credit on the 1040 Forms erred; while 8.7 percent who used the credit on the 1040A Form erred. There was also a sizable error rate by those using the general tax credit. Overall, 3.4 percent of those of those who used the credit made a mistake; while 2.4 percent of those using the 1040 Form made a mistake and 6 percent of those using the 1040A Form erred.

Table 5.—Taxpayer Math Errors—IRS Processing Year 1977 [1]

Item	Total	Error percentage on— Form 1040	Form 1040A
An error was made in figuring tax liability	1.67	1.38	2.38
General tax credit was either not computed or computed incorrectly	3.45	2.42	6.01
Error in computing the earned income credit	10.74	14.05	8.73
Standard deduction incorrectly computed	2.46	1.64	3.11
Taxpayer itemized when standard deduction was more beneficial	.7	.7	NA
Medical deduction incorrectly computed	1.37	1.97	NA
Overpayment or balance due incorrectly computed	.66	.47	.72

[1] For tax year 1976.

Source: Internal Revenue Service, Planning and Research.

3. Areas of Taxpayer/IRS controversy at the appellate level

The General Accounting Office (GAO) has been conducting studies of tax administration at the request of the Joint Committee on Taxation, including a review of areas relating to possible simplification of the Code as well as the procedures involved in taxpayer compliance and IRS administrative practices. As part of its study, GAO reviewed the various tax issues which have generated a significant degree of controversy between the IRS and taxpayers at the Service's Appellate Division level (i.e., those disagreements not resolved at the district level).[1]

The GAO reviewed the record of settlement activity at the Appellate Division for both docketed and nondocketed cases, classified by major legal issues according to the Service's "uniform issue list."[2] GAO's review covered IRS data for fiscal years 1972–1976.

The eight most significant issues identified by the GAO at the IRS appellate level (cases docketed in the U.S. Tax Court and nondocketed cases combined) were:

(1) Compensation for services;
(2) Unreported, understated, reconstructed income;
(3) Degree versus nondegree students for scholarship exclusion purposes;
(4) Support test for children of divorced parents;
(5) Definition of trade or business;
(6) Travel expenses (deduction);
(7) Education expenses (deduction); and
(8) Personal casualty loss (deduction).

In addition, the GAO identified the following six issues which comprised one percent or more of all docketed cases received: (1) Dependency exemption (Does an individual, claimed as a dependent, qualify?); (2) Dependency support (Did the taxpayer contribute more than one-half of the support of a person claimed as a dependent?); (3) Substantiation of business expenses (Issues concerning the approximation of deductible expenses under the *Cohan* rule, allocation of expenses between business and personal, and inadequate records); (4) Deduction of employee business expenses (Items subject to dispute concerning uniforms, tools, meals and lodging, use of personal residence for business purposes, as well as outlay for travel and entertainment); (5) Substantiation of deductible gifts (Essentially an issue involving inadequate records); and (6) Substantiation of

[1] Letter Report to the Joint Committee on Taxation from the Comptroller General, U.S. General Accounting Office, "Tax Issues Generating a Significant Level of Controversy" (Report No. GG7–78; June 15, 1977).

[2] The "uniform issue list" is the Service's method of describing legal problems arising under the Code and for locating subjects at issue. At the appellate level, each case is given one issue number only, based upon the classification by the docket attorney of the principal issue in controversy. "Docketed" cases are those which are to be taken further to the courts for resolution.

medical expenses (Essentially an issue involving inadequate records).

Table 6 displays the relative frequency of the above eight issues before the U.S. Tax Court, Small Tax Cases in the Tax Court, and District Court and Court of Claims for fiscal years 1975–76. Unreported, etc., income issues represented an average of 16 percent of all Tax Court cases, while travel expenses represented 14 percent of all Small Tax cases.

Table 6.—Docketed Court Cases by Major Tax Issue as a Percent of Total Disposals by Settlement

Issue and court	Fiscal year— 1974	1975	1976
(1) **Compensation:**			
Tax Court	3.25	2.87	4.16
Small Tax Cases [1]	1.79	1.62	1.21
District Court, Court of Claims	.91	.80	.56
(2) **Unreported, etc., income:**			
Tax Court	15.95	16.84	16.28
Small Tax Cases [1]	5.15	3.15	3.77
District Court, Court of Claims	1.09	.60	.21
(3) **Degree/nondegree students:**			
Tax Court	.79	.87	.82
Small Tax Cases [1]	4.93	4.92	3.55
District Court, Court of Claims	.18	.20	0
(4) **Support test for children of divorced parents:**			
Tax Court	.79	.67	.69
Small Tax Cases [1]	5.66	3.96	4.20
District Court, Court of Claims	0	0	.38
(5) **Definition of trade or business:**			
Tax Court	3.31	3.11	2.71
Small Tax Cases [1]	.11	.91	1.30
District Court, Court of Claims	1.09	2.40	1.69
(6) **Travel expense deduction:**			
Tax Court	6.63	5.44	5.76
Small Tax Cases [1]	14.96	16.40	14.50
District Court, Court of Claims	.91	2.40	2.44
(7) **Education expense deduction:**			
Tax Court	.91	.94	.57
Small Tax Cases [1]	2.69	2.08	2.42
District Court, Court of Claims	0	.20	.18
(8) **Personal casualty loss deduction:**			
Tax Court	2.27	1.27	1.74
Small Tax Cases [1]	.59	2.13	2.77
District Court, Court of Claims	.36	.40	.19

[1] Cases subject to the small case procedures of the U.S. Tax Court (under Sec. 7463 of the Code).

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IV. RECENT TRENDS TOWARD GREATER COMPLEXITY OF THE INCOME TAX LAWS

A. In General

In recent years, it is said that four general trends which complicate the tax laws have developed in tax legislation. First, it has been argued that there is an increasing trend toward using the tax system to achieve social and economic goals through provisions which are referred to as "tax expenditure" items.[1] Second, credits have been increasingly adopted instead of deductions, exclusions, or exemptions to achieve economic or social objectives. Third, there has been more frequent use of indirect methods to limit the extent to which tax incentives can be used by taxpayers to reduce their income tax liabilities. Fourth, there has been a growing trend to "fine-tune" or "target" tax expenditure provisions by adding limitations or qualification requirements to ensure that the incentive is available only for the intended purposes or beneficiaries. It has been said that this trend often involves the use of "excessive" statutory detail.[2]

In addition, the frequency with which the Congress has amended the tax laws contributes to complexity. It has been argued that simplification would be served if there were less frequent changes in the tax laws.[3] Frequent legislation affecting a large number of taxpayers can contribute to complexity because there is some uncertainty after the passage of tax legislation. In recent years, major tax legislation has been enacted every two or three years.[4] On the other hand, many significant changes made in recent legislation have simplified the law. However, it may be argued that the short-term complexities attributable to uncertainty and transitional problems arising solely from the more frequent enactment of tax legislation outweigh the long-term beneficial effect of the changes simplifying the tax law.

B. Growth in Tax Expenditures

Consistent estimates of tax expenditures became available in 1967, and have been subsequently generated annually by the staffs of the

[1] For example, see statement of Stanley S. Surrey, *Panel Discussions on the Subject of Tax Reform Before the Committee on Ways and Means*, 94th Cong., 1st Sess., at 11 (1975).

[2] For example, see statement of Boris I. Bittker, *Panel Discussions on the Subject of General Tax Reform Before the Committee on Ways and Means*, 93rd Cong., 1st Sess., at 121 (1973).

[3] For example. see Eustice, *Tax Complexity and the Tax Practitioner*, 8 Tax Adviser 27, 30 (Jan. 1977).

[4] The Tax Reform Act of 1969; The Revenue Act of 1971; the Employee Retirement Income Security Act of 1974; the Tax Reduction Act of 1975; the Tax Reform Act of 1976; and the Tax Reduction and Simplification Act of 1977.

Joint Committee on Taxation and U.S. Treasury Department.[5] Evaluation of the trends of such tax expenditures requires that the particular items be added together; however, the estimates of each item's associated revenue effect is based on the assumption that there are no interrelated effects. If a combination of some or all tax expenditures were to be eliminated, it is likely that there would be indirect, interrelated effects, e.g., if elimination of a business incentive resulted in a reduction in employment, there might be a reduction in tax collections from individuals who become unemployed and therefore partially offset the revenue gain from elimination of the incentive. Thus, adding the individual tax expenditure estimates together can be misleading. On the other hand, the mathematical sum of each tax expenditure does indicate an order of magnitude of the static effects of tax expenditures and will be used here as a rough measure of their significance.

Table 7 provides the total individual and corporate tax expenditures, their growth rates, and the growth rates of selected economic variables for 1967–1977. From these aggregates, several generalizations are possible: (1) tax expenditures have amounted to about one quarter of aggregate Federal direct spending, and this relation has been reasonably stable except for 1977, when it rose to about one-third; (2) the growth rate of tax expenditures has been variable, but tends to pattern itself after movements in the general economy; and (3) tax expenditures for individuals far exceed those for corporations, although this dominance has been declining in the last few years.

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[5] See: Joint Committee on Internal Revenue Taxation, U.S. Congress, *Estimates of Federal Tax Expenditures*, October 4, 1972; June 1, 1973; July 8, 1975; March 15, 1976; Joint Committee on Taxation, U.S. Congress, *Estimates of Federal Tax Expenditures*, March 15, 1977.

Table 7.—Estimates of Tax Expenditures: 1967–77

Fiscal year	Total tax expenditures (billions)	Tax expenditures as percent of Federal budget	Percent individual tax expenditures	Percent corporate tax expenditures	Growth rate in tax expenditures (percent)	GNP growth rate (percent)	Inflation rate (percent)
1977	[1] $114.470	32.3	76.4	23.6	16.2	11.1	6.0
1976	[2] 98.530	25.3	73.7	26.3	6.1	6.2	5.8
1975	[2] 92.865	26.0	76.0	24.0	13.2	−1.8	9.1
1974	[3] 82.015	27.4	76.6	23.4	10.2	−1.7	11.0
1973	[4] 74.441	28.1	75.2	24.8	24.5	5.5	6.2
1972	[5] 59.810	24.4	77.7	22.3	15.7	5.7	3.3
1971	[6] 51.710	23.4	80.9	19.1	17.7	3.0	4.3
1970	[6] 43.950	21.5	85.5	14.5	−5.8	−.3	5.9
1969	[6] 46.640	24.7	NA	NA	5.7	2.6	5.4
1968	[6] 44.140	24.4	NA	NA	20.7	4.4	4.2

[1] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures*, Mar. 15, 1977, table 1.

[2] Joint Committee on Internal Revenue Taxation, *Estimates of Federal Tax Expenditures*, Mar. 15, 1977, table 1.

[3] Joint Committee on Internal Revenue Taxation, *Estimates of Federal Tax Expenditures*, July 8, 1975, table 1.

[4] Unpublished Treasury Department table, calendar year basis.

[5] Joint Committee on Internal Revenue Taxation, *Estimates of Federal Tax Expenditures*, June 1, 1973, table 1.

[6] Joint Committee on Internal Revenue Taxation, *Estimates of Federal Tax Expenditures*, Oct. 4, 1972, table 1.

C. Use of Credits

1. In general

Since 1970, a significant number of credit provisions have been enacted. The following table lists the principal credits and their purposes:

TABLE 8.—CREDITS ENACTED: 1971–77

Item	Act	Purpose
1. Investment credit[1]	Revenue Act of 1971	Economic stimulus for capital investment.
2. Work incentive credit	do	Employment of welfare recipients.
3. Contributions to candidates for public office.	P.L. 93–625	Participation in political process.
4. General tax credit	Tax Reduction Act of 1975.	Tax reduction for economic stimulus.
5. Earned income credit	do	Relief for low-income individuals with children.
6. Purchase of new principal residence.	do	Economic stimulus for housing industry.
7. Welfare recipient	do	Employment of welfare recipients.
8. Child care credit	Tax Reform Act of 1976.	Expansion of coverage and simplification of prior law.
9. Jobs credit	Tax Reduction and Simplification Act of 1977.	Reduction in unemployment.

[1] The investment credit was restored in 1971 after its repeal in 1969. It was originally enacted in 1962.

In general, there are two basic reasons for the greater use of tax credits for achieving various objectives. First, a tax credit generally provides the same amount of tax benefit for low- and middle-income taxpayers as for high-income taxpayers. By comparison, a larger or new exemption, exclusion, or deduction provides a greater benefit to high-income taxpayers under the graduated rate structure because an exemption, exclusion, or deduction reduces tax liability at a taxpayer's marginal tax rate (i.e., the bracket in which the last dollar of income is taxed).

A second reason for adopting a credit is that the relief or incentive is available to taxpayers who do not itemize deductions, whereas a deduction would not benefit these taxpayers.

2. Complicating characteristics of credits

Three usual characteristics of credits tend to make them inherently more complicated than itemized deductions. First, the computation of the amount of the credit usually involves an additional mathematical step in which the amount of the base is multiplied by the percentage rate of the credit. Second, a credit potentially affects a larger number of taxpayers than would an itemized deduction because a credit can be claimed even though the taxpayer uses the standard deduction. Consequently, many more taxpayers have to maintain records concerning the expenses with respect to which a credit is allowed. Third, because most credits are not refundable, special stacking or ordering rules must be provided to determine which of several credits available are actually applied against tax liability. These ordering rules require several lines on each of the forms used for claiming a credit. In addition, rules may also be needed to determine carryback and carryover amounts for unused credits. These rules must be coordinated with the net operating loss carryback rules because a loss carryback from a subsequent year will affect the amount of a credit limitation based on the tax liability for the preceding year.

An additional complicating feature of the credit for contributions to candidates for political office is that taxpayers have an option between claiming a credit of one-half of a limited amount of the contributions or an itemized deduction for a limited amount of the contribution. As a result, taxpayers who itemize deductions must determine the relative advantages of claiming a credit or an itemized deduction.

In general, the credits available to individual taxpayers can be classified in two categories for purposes of considering their impact on tax complexity. The first category of credits includes business related credits such as the investment tax credit, the WIN credit, and the jobs tax credit. The second category includes individual credits not related to an active trade or business although they may be related to a taxpayer's employment. It may be argued that concern over complexity attributable to business-related credits should not be as great as concern for complexity of the other credits. This argument is basically founded on the assumption that a taxpayer who is engaged in an active trade or business will ordinarily obtain professional assistance in tax matters and, therefore, will not be as greatly affected by complexities. In addition, the business-related credits affect a smaller number of individual taxpayers. However, complexity remains a concern for small businesses.

In the case of credits available to individual taxpayers, there may be a greater cause for concern over complexity because of their effect on low- and middle-income taxpayers. Credits in this category include the general tax credit, the earned income credit, the political contributions credit, the child care credit, and, for several taxable years, the new principal residence credit.

It should be noted that the Tax Reduction and Simplification Act of 1977 made several changes designed to simplify the application of the general tax credit. As a result of this Act, the general tax credit is built into the tax table and taxpayers who use the table need not actually compute it.

D. Indirect Methods of Limiting Preferences

1. In general

Since the early 1960's, a number of provisions have been enacted to limit indirectly the amount of tax benefits which a taxpayer may receive under the tax incentive provisions. The principal provisions added to limit tax preferences are set forth in the following table:

TABLE 9.—INDIRECT METHODS OF LIMITING PREFERENCES: 1962–77

Item	Act	Purpose
1. Depreciation recapture for personal property.	Revenue Act of 1962.	Prevent conversion of ordinary income to capital gain.
2. Depreciation recapture for real property.	Revenue Act of 1964.	Do.
3. Minimum tax	Tax Reform Act of 1969.	Limited tax benefit of certain preferences.
4. Farm loss recapture	do	Prevent conversion of ordinary income to capital gain.
5. Recapture of write-offs for soil and water conservation expenditures and land-clearing costs.	do	Do.
6. Limitation on investment interest.	do	Limit use of investment interest to shelter income.
7. Reduction in amounts eligible for maximum tax by tax preferences	do	Limit benefit of maximum tax for benefit attributable to preference.
8. At-risk rules	Tax Reform Act of 1976.	Limit tax writeoffs to amounts invested or at risk.
9. Recapture from disposition of oil and gas property.	do	Prevent conversion of ordinary income to capital gain.
10. Amortization of construction period interest and taxes.	do	Prevent immediate writeoff of construction period interest and taxes.
11. Production costs for films and books.	do	Require production costs to be deducted over income period.
12. Accrual accounting for farm corporations.	do	Require accrual accounting and capitalization of preproduction expenses for certain farm corporations.

In addition, several of these provisions have been amended to broaden their impact. For example, the real property depreciation recapture rules were expanded in 1969, and in 1976. Major changes to the minimum tax provisions were made in 1976, including the treatment of "excess" itemized deductions as a tax preference.

2. *Complicating characteristics*

These provisions complicate the Code in several ways. First, at least two computations must be made: the basic preference must be computed and then computations must be made for the limiting device. Separate forms and instructions are ordinarily required for the latter computation. Second, many of the techniques to limit the preferences are not commonly used in the measurement of income and, consequently, the rules raise many new interpretative problems. Thus, in terms of both uncertainty and additional records and computations, substantial complexity may be added. As a result, the preference-limiting devices add considerable difficulty in evaluating the tax implications of a proposed transaction.

E. "Fine-Tuning" Tax Expenditures

1. In general

There are generally four different instances when the Congress enacts legislation designed to "fine-tune" the tax system. First, the Congress may pass legislation designed to tighten up an existing deduction, credit, or exclusion if it believes that there is an unintended application of the tax benefit of the deduction, credit, or exclusion. This can occur if a particular situation was neither considered nor foreseen when the initial legislation was drafted, where there has been some creative tax planning, or a court decision or an Internal Revenue Service ruling is thought to be inconsistent with the policy of the initial legislation.

Second, the Congress may expand an existing rule to reach cases not initially covered. This can occur if a particular situation was overlooked when the legislation was originally considered if new situations develop subsequent to the original action, or a judicial or administrative decision interprets the initial legislation more narrowly than the Congress desires.

Third, the Congress may pass legislation to clarify an unclear rule. An unclear rule can exist because of varying judicial or administrative interpretations, or it can arise from the need to provide a rule where no rules existed before and general tax principles do not provide a clear rule.

Fourth, the Congress passes tax legislation designed to implement some new tax policy. As times change, so do the incentives and penalties of the tax system. In enacting this legislation, existing provisions may be "fine-tuned" to conform to the new policy.

Many examples of these four cases can be found in tax legislation enacted in recent years that have added to the complexity of the tax system. Examples of "fine-tuning" legislation include the private foundation rules enacted in 1969, portions of the Employee Retirement Income Security Act of 1974, and the revisions of the DISC provisions in 1976.

2. Complicating characteristics

Several characteristics of "fine-tuning" tax legislation add to complexity. Invariably, "fine-tuning" involves the adoption of special qualification requirements and limitations to target the provision. In many cases, "fine-tuning" legislation requires considerable statutory detail. Another characteristic of fine-tuning legislation is the tendency to provide transitional rules to protect existing arrangements or to phase in the impact of the changes. Transitional rules make comprehension of the law more difficult.

[illegible]

V. ISSUES IN SIMPLIFICATION OF THE INDIVIDUAL INCOME TAX

A. In General

This portion of the report discusses the principal issues and problems of simplification of specific provisions relating to the individual income tax. The discussion generally is limited to issues and problems affecting a significant number of individual taxpayers because (1) more taxpayers are involved, and (2) the effect of complexity on the voluntary self-assessment system is perceived by many to be greater for these taxpayers.[1]

The discussion of issues relating to a specific item covered by the report is arranged under broad topical categories based on the primary characteristic of the items within a category, i.e., exclusions, credits, itemized deductions, etc.

A number of issues and problems apply generally to a wide range of possible simplifying changes. The issue of tax equity frequently arises when considering the possible repeal or restriction of a provision benefiting a particular class of taxpayers. Depending upon the provision, the equity arguments against repeal or revision may be made in terms of vertical equity or horizontal equity.

In reviewing existing social and economic incentive provisions under existing law, the basic issues would appear to be:

(*a*) What effect, if any, would continuation, repeal, or revision have on tax equity?

(*b*) Does the provision continue to promote desirable social or economic purposes?

(*c*) Is the tax incentive approach the most efficient method of achieving the desired objective?

(*d*) Would there be serious disruption of the economy if the provisions were repealed or significantly modified?

Another problem common to most proposals to simplify the law by repealing or revising a provision is its effect upon taxpayers who

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[1] This does not mean there is no need to review other areas for simplification purposes. For example, a review of other areas might include the areas of installment sale reporting and property settlements incident to a divorce. In addition, simplification through structural changes might be achieved in the income tax treatment of corporations, partnerships, and trusts and estates. In a broader review for simplification purposes, the areas could include accounting rules (including differences between tax and financial accounting), inventory rules, qualified retirement plans, the treatment of foreign business income (including the subpart F rules), the Domestic International Sales Corporation (DISC) rules, depletion and depreciation rules, the carryover basis rules, and the investment tax credit. Such a review could also include all of the mechanisms for limiting tax preferences, e.g., the recapture and at-risk rules. Finally, limitation of the discussion to income tax issues and problems affecting individual taxpayers should not be taken as a suggestion that other taxes, such as estate and gift taxes and excise taxes, cannot be simplified.

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have entered into transactions in "reliance" upon the tax incentive provision. In some cases, a transaction extending over a period of several years might not have been economically feasible but for the tax incentive, e.g., a transaction involving long-term debt which is economically feasible only if interest is deductible. If repeal or revision of a provision is considered, this "reliance" problem raises issues as to whether there should be transitional rules to protect prior transactions. Transitional rules would ordinarily contribute toward complexity.

If, instead of considering repeal or significant contraction of coverage of a provision, the focus is on structural improvements of a provision for simplification purposes, a number of basic issues are common to all provisions. In general, these issues are:

(*a*) Are the existing requirements or limitations necessary or appropriate to prevent abuse and excessive or unintended benefits?

(*b*) Can definitional problems be solved by providing broad statutory guidelines or are detailed statutory guidelines necessary?

(*c*) Can complex computations be eliminated by combining limitations or by substituting an easier computation designed to achieve rough justice for a more precise method of calculation?

B. Exclusions From Income

1. In general

The Internal Revenue Code begins with a very broad definition of gross income and then sets forth specific exclusions from the general definition. Thus, the general rule provides that, in the absence of provisions to the contrary, "gross income means all income from whatever source derived" (sec. 61). However, many exclusions have been provided. Some of these have been provided in the Internal Revenue Code itself; others have been provided in legislation outside the Code; and still others are based on judicial authority or administrative practice. Those items which are excluded from the gross income of individuals by specific Code provisions include the following:

1. Prizes and awards received in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement (sec. 74 (b)).
2. The cost of employer-financed group term life insurance subject to a per-employee ceiling of $50,000 (sec. 79).
3. Certain life insurance proceeds and employee death benefits (sec. 101).
4. Gifts and inheritances (sec. 102).
5. Interest on certain State and local governmental obligations (sec. 103).
6. Compensation for injuries or sickness (sec. 104).
7. Amounts received under accident and health plans (sec. 105).
8. Contributions by employers to accident and health plans (sec. 106).
9. Rental value of parsonages (sec. 107).
10. Income from the discharge of indebtedness (sec. 108).
11. Improvements by a lessee on a lessor's property (sec. 109).
12. Recovery of bad debts, prior taxes, and delinquency amounts (sec. 111).
13. Certain combat pay for members of the Armed Forces (sec. 112).
14. Mustering-out payments for members of the Armed Forces (sec. 113).
15. Partial exclusion of dividends received by individuals (sec. 116).
16. Scholarships and fellowship grants (sec. 117).
17. Meals or lodging furnished for convenience of employer (sec. 119).
18. Amounts received under qualified group legal services plans (sec. 120).
19. Gain from sale or exchange of residence of individual who has attained age 65 (sec. 121).
20. Certain reduced uniformed services retirement pay (sec. 122).
21. Amounts received under insurance contracts for certain living expenses (sec. 123).

22. Exclusion for current employer contributions and earnings under qualified retirement plans (secs. 402 and 403).

23. Certain income earned abroad by nonresidents or citizens living abroad (sec. 911).

24. Allowances for certain Federal civilian officers and employees stationed overseas and Peace Corps volunteers (sec. 912).

25. Certain income from sources within the possessions of the United States (sec. 931).

Among the items specifically excluded from gross income by other provisions of law are veterans benefits, income transfer or welfare payments (such as Railroad Retirement benefits, public assistance benefits, and unemployment benefits) and certain other benefits for members of the Armed Forces. (By Internal Revenue Service ruling, social security benefits are also excluded from income.)

Also, under judicial decisions and administrative practice (or inaction), certain other items normally referred to as "fringe benefits" may be excluded from income. These items include benefits such as employees' discounts, free airplane travel, and personal use of business property such as hunting lodges, yachts, etc.

On the basis of estimates for fiscal 1977, the exclusions for individual taxpayers involving the most revenue (more than $1 billion) were:

	Billions
1. Net exclusion of pension contributions and earnings	$10.020
2. Exclusion of employer contributions for medical insurance premiums and medical care	5.195
3. Exclusion of social security benefits	4.235
4. Exclusion of unemployment insurance	2.755
5. Exclusion of interest on general purpose State and local debt	1.680
6. Exclusion of benefits and allowances to Armed Forces personnel	1.095

Because of the wide variety of exclusions and their diverse origins, they cannot be categorized precisely according to the reasons for their existence. However, some exclusions, such as governmental transfer (or welfare) payments and veterans benefits, have been exempted at least in part because the exemption is viewed as a more efficient way of giving the same after-tax benefit to recipients than a system of making larger taxable payments and then collecting the tax (although this may not have been the original reason for the exemption). The exclusion of certain other items may be explained, at least in part, by valuation difficulties attributable to their relatively small value and their receipt in kind rather than cash. Among the items which have been excluded, at least in part, because of their noncash nature and the inability to measure their value with any degree of precision include certain employee discounts, meals and lodging furnished for the convenience of an employer, and the income resulting from imputed net rental income from a home owned and occupied by the taxpayer.[2]

Other exclusions have been provided because a particular type of economic benefit has not been traditionally thought of as income. Examples of these exclusions are gifts and inheritances. Another argument made for these exclusions is that gifts and inheritances are subject to separate estate or gift taxes.

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[2] See generally Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 Harv. L. Rev. 925, 934–8, 943–50 (1967), for a discussion of many excluded items, especially items which are difficult to measure.

The exclusions discussed above generally relate to the income tax treatment of the recipient of cash, services, property rights, and other benefits. However, at least in some circumstances, it may be argued that an income tax exclusion is provided to the transferor of appreciated property. Thus, it may be argued that the failure to include in the donor's income the unrealized appreciation of donated property (which is not done except in the case of certain transfers to a political organization) could be considered an income tax exclusion, since, in making a gratuitous transfer, the donor has exercised control and dominion over the unrealized appreciation and the transfer should be treated as a "realization" of the appreciation.

A substantial number of the exclusions are based upon a desire to benefit specific types of individual taxpayers or to encourage employers to provide certain types of benefits (such as accident and health insurance, group legal services, etc.). The exclusion for employer contributions to qualified retirement plans is one of several incentives designed to encourage the establishment and maintenance of private retirement plans.

Another type of exclusion essentially deals with the time for recognition of income. An example of this is the exclusion for income from cancellation of indebtedness where the taxpayer agrees to make adjustments to the basis of property.

The partial exclusion of dividends received by individuals is not only intended to reduce the double taxation of corporate profits but also to encourage investment in corporate stock. The exclusion for interest on State and local government obligations is intended to aid those governments through lower borrowing costs which result from the special exempt status for Federal income tax purposes.

2. Issues involved in the consideration of repeal or revisions of exclusions

In addition to the general issues arising in connection with the consideration of the repeal or revision of any special tax provision, a number of issues particularly related to exclusions from income would arise. One issue that may be of great significance in a review of exclusions concerns the impact of change upon funding required to maintain the same level of after-tax benefits. In general, elimination of exclusions would affect employers and State and local governments. For employers, changes in the exclusion rules for unemployment compensation, workmen's compensation, social security, qualified pension plans, meals and lodging for the convenience of the employer, and in-kind fringe benefits might increase their compensation expenses if their employees demand the same after-tax benefits. The increased costs might affect consumers to the extent employers could pass the increases on in higher prices.

Elimination or curtailment of the exclusion for interest on State and local government obligations would drive up the cost of borrowing of State and local governments. The additional costs would ordinarily result in an increase in the State and local taxes levied to service the debt. For this reason, many proposals to eliminate the exclusion have suggested a Federal subsidy for the interest rate differential between taxable obligations and exempt obligations. Under these proposals, the subsidy level would have to be established and some assurance of the subsidy's continuation would have to be provided.

Most programs which would repeal or significantly restrict exclusions could increase the number of individuals required to file tax returns. In particular, a substantial increase in the number of individual income tax returns could result from any "comprehensive tax base" proposal pursuant to which governmental transfer payments would be taxed. Since adoption of such a proposal could add some individuals to the tax rolls, it could contribute toward complexity for affected taxpayers. Of course, the number of individuals added to the tax rolls would depend upon the filing requirement level reflecting personal exemptions and the "standard" deduction. On the other hand, for the Internal Revenue Service, the proposal might contribute toward simplification in interpreting the law. However, the additional returns required to be filed might increase the Service's manpower needs to process and audit returns (it is possible that some existing personnel could be merely shifted to this function if major simplification decreased manpower needs for other functions).

The elimination of certain exclusions could result in additional complexity. For example, valuation of employee discounts and meals and lodging furnished for the convenience of the employer could be exceptionally difficult unless there were some ascertainable market value for the particular items.

Some exclusions, however, are predicated upon satisfaction of complicated or vague qualifications. As a consequence, considerable difficulty results. An example of this is whether certain stipends are excludable as scholarships or fellowships or are taxable as payments for services. This problem has been acute in many types of graduate programs, especially those involving physicians. There are also a number of areas where limitations on the availability of the benefit and phaseouts require some mathematical calculations. Two areas which involve substantial calculations are the exclusion for disability income and the partial exclusion of the gain from a sale of a residence by persons age 65 or over.

Some exclusions involve complexity in tax planning rather than in return preparation. This complexity may often involve structuring a transaction so that the income qualifies for exclusion. A primary example of this is structuring a State or local bond issue so that the interest is eligible for exclusion from income rather than being taxable because of the rules relating to industrial development bonds or arbitrage bonds.

3. *Specific areas of complexity*

A review of the exclusion provisions for purposes of simplification indicates that several provisions produce an inordinate amount of confusion or litigation. These provisions are the exclusion for scholarships and fellowships, the exclusion for an employee's contributions under a qualified annuity plan, and the exclusion for foreign source income.[3]

a. Scholarships and fellowships

In general, scholarships and fellowships are excluded from gross income, as are certain amounts received to cover expenses for research, travel, clerical help and equipment. In the case of a non-degree can-

[3] The provisions relating to industrial development bonds and arbitrage bonds are generally considered to be complex. They are not described here because the complexities affect the issuers of the bonds and do not ordinarily affect an individual taxpayer in the preparation of his income tax return.

didate, an exclusion is available only for up to $300 per month for no more than 36 months and then only if the grantor of the scholarship is a qualified governmental unit, charity, or international organization. (Issues concerning the treatment of degree versus nondegree students are identified as an area of significant controversy in section III of the report.)

While there are few computational complexities or forms problems, serious definitional problems have arisen. The exclusion for scholarships and fellowship grants has been interpreted to be restricted to educational grants by relatively disinterested grantors who do not require any significant consideration from the recipient.[4] The problem of determining whether a particular stipend made in an educational context is a scholarship or is compensation for services has been particularly troublesome in situations where the recipient performs services which are related to his education and which also benefit the grantor. In addition, some disputes have focused on whether certain stipends are taxable compensation to the recipient's parent if the parent is an employee of the grantor (or of a company which is related to the grantor) and the eligibility for stipends is limited to children of persons employed by the grantor (or company). Problems have also arisen with respect to so-called "tuition remission" plans under which a child of an employee of an educational institution is charged less tuition than other students.

It could be argued that repeal of this exclusion would eliminate these controversies without unduly burdening most recipients, since they are in very low tax brackets or below the taxable level. The Congress could consider using the increased revenue from repeal (estimated to be $250 million for fiscal 1977) for direct Federal spending on education or for loan guarantee programs. However, repeal of the exclusion would have an adverse effect on many private grant-making organizations that would have to provide larger grants to compensate for the change in tax treatment.

b. Employee's contributions to annuity

In general, amounts received under an annuity are includible in income except to the extent that the amounts received represent recovery of the annuitant's contributions. This cost recovery normally is computed by prorating the cost over the expected return, i.e., over the annuitant's life expectancy in the case of an annuity for life. However, a special rule provides that, in the case of annuity payments made under a qualified plan to which both the employer and the employee have made contributions, all amounts received from the annuity are to be excluded until the employee's contributions are recovered, and thereafter the full amount of the annuity payments is includible in income. This rule, however, applies only if the amounts receivable in the first 3 years after the starting date of the annuity would equal or exceed the employee's contributions.

This pro rata exclusion rule involves some relatively complicated computations. If the employee is required to make the computations himself (as opposed to situations where this is done by the payor), significant complexity in preparation of the return results.

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[4] *Bingler* v. *Johnson*, 394 U.S. 741 (1969).

The Treasury Department's "Blueprints for Basic Tax Reform" proposed that the law could be simplified by allowing current deductions for the employee's contributions to any contributory qualified retirement plan, taxing currently the earnings of the plan, and then taxing in full the annuity payments. (That report is summarized in section VI.)

c. Earned income of citizens working abroad

United States citizens working abroad may exclude up to $15,000 of earned income (up to $20,000 for employees of United States charitable organizations) if certain residency or "presence abroad" standards are met. However, foreign taxes paid on income eligible for the exclusion are not allowed as a foreign tax credit against U.S. income tax; income derived in addition to the income eligible for exclusion is subject to U.S. tax at the higher rate brackets which would apply if the excluded income were also subject to tax; and income earned abroad which is received outside of the country in which earned in order to avoid tax in that country is not eligible for exclusion.

The rules which stack the excluded amount of earned income at the bottom of the taxpayer's rate brackets were provided (in the Tax Reform Act of 1976) to avoid giving greater benefits from the exclusion to taxpayers in higher brackets. An exclusion which is stacked at the top of the taxpayer's rate brackets, as other exclusions are stacked, results merely in omitting the item from the income computation. However, by stacking the foreign income exclusion at the bottom bracket, two computations of tax are required. First, tax is computed on taxable income without regard to the exclusion. Then, tax is computed on the excluded income as if it were the only income earned (and thus taxed at the bottom of the taxpayer's rate brackets). The difference between the two amounts computed represents the income tax imposed before credits. Additional complexity is generated by the disallowance of the credit for foreign taxes paid on the excluded income (including the question of how to "stack" the excluded income for purposes of the disallowance of foreign taxes).

The complexity of this provision could be substantially reduced without any significant substantive change by changing it from an exclusion to a credit. Thus, if a credit were allowed in an amount equal to 20 percent of the first $15,000 of gross income earned abroad (reduced by the expenses of earning that income), approximately the same benefit could be achieved without the same degree of computation complexity." [5]

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[5] This change would tend to give a somewhat greater buefit than present law to taxpayers whose excludable income earned abroad is significantly less than $15,000 per year.

C. Deductions From Gross Income in Computing Adjusted Gross Income

1. In general

Under present law, certain deductions are allowed to all taxpayers, including those who do not itemize deductions. These deductions are taken into account in computing adjusted gross income and are commonly called "above-the-line" deductions. Most of these deductions are for expenses incurred in connection with a taxpayer's trade or business.

Generally these deductions can be placed in the following six categories:

(1) Deductions attributable to a trade or business carried on by the taxpayer, other than the performance of services by the taxpayer as an employee.

(2) Certain deductions and losses attributable to investment income or investment property (including the deduction for one-half of net long-term capital gain).

(3) Certain trade or business deductions of employees which are—
- (*a*) reimbursed by the employer;
- (*b*) expenses for travel away from home;
- (*c*) transportation expenses; or
- (*d*) expenses incurred by an outside salesman.

(4) Certain deductions for contributions to qualified retirement plans and for lump sum distributions from qualified plans which are subject to a special tax rather than the regular income tax.

(5) The moving expense deduction.

(6) The deduction for alimony payments.

The basic purpose of most items in the first three categories is to allow deductions for the costs incurred in earning income (the most notable exception being the deduction for one-half of net long-term capital gain). Generally, the allowance of these deductions is necessary to determine the taxpayer's net income. The majority of the items in these categories are simply the ordinary and necessary expenses incurred in a trade or business. One type of deduction in these three categories is the deduction for a loss from the sale or exchange of property held for the production of income. Another type is the deductions for expenses attributable to the production of rents or royalties. A third type covers penalties imposed because of premature withdrawals of funds from time-savings accounts or deposits. Although the three types of deductions described above do not, strictly speaking, solely involve expenses of earning income, they reflect some of the expenses of activities engaged in for profit. (Certain other expenses incurred in connection with activities engaged in for profit are deductible as itemized deductions, e.g., investment interest.)

A major purpose of some of the above-the-line deductions is to provide an incentive for certain socially or economically desirable activities. In some cases, the incentive is provided by accelerating the time for claiming a deduction which ordinarily would be allowable at a later time, or over a longer period. Examples of these are the provisions dealing with depreciation, and a substantial number of Code sections which allow certain types of rapid amortization in lieu of depreciation. Moreover, other provisions allow the current deduction of certain items which normally must be capitalized. One of these is provided under section 174, which allows a current deduction for certain research and experimental expenditures.

There are also incentive provisions which allow current deductions for amounts that would otherwise be capitalized and taken into account as an adjustment to basis upon sale or exchange of the property (rather than deducting the amounts as depreciation or amortization over the useful life of the property). An example of this is the provision which allows a current deduction for certain land—clearing expenditures by farmers that would normally be added to the basis of nondepreciable land.

The fourth category of above-the-line deductions for an individual involves certain items relating to pension plans or retirement savings plans. A primary item in this category is the deduction allowed for contributions to an individual retirement account, bond, or annuity. Also, deductions for a self-employed individual's contributions to a qualified retirement plan are in this category.[6] Generally, these deductions are provided in order to encourage retirement savings.

In essence, the moving expense deduction reflects two policies: first, the policy of considering as an employment expense the cost of a substantial relocation to accept a new position and, second, an ability-to-pay concept.

The alimony deduction reflects the fact that the taxpayer's ability to pay has been reduced by alimony payments and the fact that the recipient must report alimony as income.

2. *Issues involved in the consideration of repeal or revision*

The most important issues arising in connection with any simplification proposal which would entail the repeal or significant restriction of many above-the-line deductions would be equity issues. These issues necessarily would include the ability-to-pay concept, e.g., the costs of earning income should be taken into account because net income gives a better measurement of ability to pay than does gross income.

An issue pertaining to above-the-line deductions concerns the question of why certain expenses of earning investment income are treated as itemized deductions while others are treated as above-the-line deductions. This is particularly true, for example, of interest paid to carry investments in stocks or interest-bearing securities and of the employee business expenses which are currently treated as itemized deductions.

3. *Specific areas of complexity*

a. Moving expenses

A deduction for certain expenses of moving to a new principal place of work is allowed to an employee or self-employed individual who

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[6] The other deductions in this general category include a deduction for certain lump sum distributions which are taxed separately and a deduction allowed for shareholders of subchapter S corporations for forfeitures of excess contributions which have been included in income by them.

incurs the expenses in connection with the commencement of work at a place which is at least 35 miles farther from his former residence than was his former principal place of work, and who is a full-time employee in the new general location for at least 39 weeks during the next 12 months (78 weeks during the next 24 months for self-employed persons).[7] Deductible moving expenses are the expenses of transporting the taxpayer and members of his household, as well as his household goods and personal effects, from the old to the new residence; the cost of meals and lodging en route; the expenses for premove househunting trips; temporary living expenses for up to 30 days at the new job location; and certain expenses related to the sale or settlement of a lease on the old residence and the purchase of a new residence at the new job location. However, the deduction for premove househunting and temporary living expenses at the new job location cannot exceed $1.500 and the deduction for qualified expenses for the sale, purchase, or lease of a residence cannot exceed $3.000 (reduced by any deduction claimed for premove househunting or temporary living expenses). Special rules are provided for members of the Armed Forces, taxpayers with no former principal place of work, and certain exceptional cases of involuntary separation from the new employment.

These complicated qualifications result from an attempt to distinguish between the normal, personal expenses of moving (or moves made for personal purposes) and costs related to the production of income from employment at the new principal place of work. Since the revenue cost and equity problems may not permit a substantial expansion in the type or amounts of costs allowable as deductions, any simplification would seem to depend on the repeal of the provisions or a cutback in the types of expenditures allowed as deductions.

Since the moving expense deduction is allowed only for certain types of expenses and limits are placed on some categories of expense (e.g., sale of residence, pre-move expenses and temporary living expenses), the Moving Expense Adjustment Form (Form 3903) is rather complicated. Substantial simplification of the form and computations would be possible if one overall limit were placed on allowable expenses. However, this would mean that the basic cost of moving household goods, now allowable in full, would have to be limited in order to prevent excessive claims for the currently restricted categories. In addition, elimination of the separate limitations might decrease equity as between taxpayers who rent their homes and those who own their homes. Alternatively, the full cost of basic moving expenses could be allowed while disallowing some or all of the items which are currently subject to limitation, such as expenses incident to the sale of the former residence.

b. Alimony

An above-the-line deduction is allowed to a taxpayer who is divorced or legally separated for the amount of alimony paid to the extent it is includible in the spouse's income as periodic payments received in discharge of a legal obligation or of certain separation agreements.

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[7] Any amount received directly or indirectly as a reimbursement of moving expenses must be included in a taxpayer's gross income as compensation for services (sec. 82), but he may offset this income by deducting expenses which would otherwise qualify as deductible items (sec. 217).

No deduction is allowed for child support payments or for payments discharging a principal sum (i.e., a property settlement), except in certain circumstances in which such payments are to be paid (or may be paid) over a period of more than 10 years.

As a result of the Tax Reform Act of 1976, the alimony-paid deduction is now an adjustment to gross income and therefore available to taxpayers claiming the standard deduction. There are no important computational problems, and the form is not complicated by this provision. The most serious complexity in this area involves the distinction between deductible alimony on the one hand and nondeductible payments for child support or for the discharge of a principal obligation on the other hand.

Simplification could be achieved by eliminating these distinctions and treating all payments made by one former spouse to the other as income to the payee and as a deduction to the payor. However, this would raise several equity issues. Since the payor would benefit from larger alimony deductions and the payee would have greater income, existing agreements would have to be modified or excepted from the provisions. Also, it appears unfair to treat the payee spouse as a recipient of income for amounts which are received in payment for her share of marital property (at least to the extent such amounts do not exceed basis) or for amounts which are properly attributable to the satisfaction of the payor's personal obligations to support minor children. Furthermore, allowance of a deduction for child support payments would, in effect, give the payor spouse a deduction for expenses of raising his children even though these expenses (except for medical expenses) are nondeductible personal expenses for other taxpayers.

Alternatively, simplification could be achieved by eliminating these distinctions and providing that alimony is neither income to the payee spouse nor deductible to the payor spouse. The major problem with this approach would be that it does not take into account the payor's reduced ability to pay. Another alternative might be to provide that specified minimum amounts of payments from the payor spouse to the payee spouse (based on a specified figure per child) would have to be treated as nondeductible child support. Such an approach might result in some simplification but it fails to take into account the varying costs of living in various portions of the country and the different needs of, and normal standards of living of, different individuals.

c. Employee business expenses

Employees are allowed "above-the-line" deductions only for certain specified trade or business expenses. (Some of the employee business expense items are included in the areas of significant controversy in section III of the report.) Deductions are allowed for an employee's expenses for transportation and expenses for travel, meals, and lodging while away from home in connection with his employment. Employees may deduct other employment-related expenses for which they are reimbursed by the employer. Outside salesmen may deduct all trade or business expenses incurred while away from the employer's place of business.

The deduction for employee business expenses inherently involves detailed record-keeping and a lengthy form (Form 2106). There are few computational difficulties, except for the limitations on certain expenses to the amount of reimbursement, but the definitional complexities are great. For example, the distinction between deductible transportation expenses and nondeductible commuting expenses can be difficult to administer. While it may not be feasible or desirable to disallow all employee business deductions, some simplification could be achieved by disallowing deductions for unreimbursed employee business expenses below a floor and by tightening specific provisions, such as the unreimbursed use of a personal automobile, so that fewer taxpayers would be involved.

d. Entertainment expenses

Generally, entertainment expenses are deductible if they satisfy the ordinary and necessary standard, certain special requirements (sec. 274(a)), and substantiation rules (sec. 274(d)). In the case of a self-employed individual, the allowable expenses are treated as above-the-line deductions. In the case of an employee, the allowable unreimbursed expenses are generally treated as itemized deductions. For convenience the discussion of these expenses is set forth here.

There are a number of definitional problems concerning entertainment expenses that contribute to complexity. For example, the basic question of whether an entertainment expense is an "ordinary and necessary" expense incurred in connection with a trade or business can arise in a multitude of factual circumstances. In addition, the special rules for entertainment activities contribute to complexity, e.g., the bona fide business discussion requirement and the quiet business meal rules (sec. 274). Additional problems arise in connection with the special rules for entertainment facilities, such as a country club or hunting lodge, which must be used primarily for the furtherance of the taxpayer's trade or business. The record-keeping requirements under the substantiation rules also contribute to complexity.

Another aspect of the deduction for entertainment expenses concerns tax evasion and the administrative problems faced by the Internal Revenue Service. In fact, the special entertainment rules and substantiation requirements were enacted in part as a response to what was perceived to be widespread abuse in claiming deductions.

e. Special problems of small business

For small businessmen, almost all of the above-the-line trade or business expenses may involve some complexity. However, their primary concern is more frequently related to problems of excessive regulation, involving paperwork and filing requirements. When raised, the problems for above-the-line deductions generally concern the three broad areas of inventories, depreciation methods, and qualified retirement plans.

In inventory accounting, the basic problem is preparing and maintaining adequate records. While this problem may be one for which no relief can be provided, the small businessman may be precluded from adopting the so-called last-in-first-out (LIFO) method of inventory pricing because of the significantly greater record-keeping and qualification requirements. It has sometimes been suggested that a streamlined, less complicated LIFO inventory method should be provided for small businesses.

In the case of depreciation, it may be argued that the small businessman may not have the sophistication or access to professional assistance to take advantage of the special depreciation rules because of their complexity. The solutions for this particular problem may be extremely difficult. For example, the substitution of a "cost recovery" system for the depreciation system would entail the adoption of arbitrary write-off periods for capital purchases. In some cases, such an approach might actually be detrimental to small business, e.g., by creating unusable net operating loss carrybacks and carryovers.

In the case of qualified pension plans, the small businessman generally has to satisfy the same qualification and reporting requirements applicable to the largest corporations in the country. The issuance of model plans and the preapproval of pattern, master, and prototype plans by the Internal Revenue Service simplifies some of the problems incident to the initial adoption of a plan. However, annual reporting requirements, and the need to obtain an actuarial certification of the funding of benefits under a defined benefit plan, may impose a costly compliance burden on a small business. One possible way to alleviate these problems for small business would be for the Service to develop an abbreviated annual report that would satisfy reporting requirements for the Service, the Department of Labor, and the Pension Benefit Guaranty Corporation.

D. Itemized Deductions

1. In general

Generally, no deductions are allowed for personal, living, and family expenses. However, some personal expenses are deductible as itemized deductions. These include medical expenses, charitable contributions, nonbusiness casualty losses, personal interest expenses, and certain taxes. Thus, many of the itemized deductions relate to personal expenses. However, certain investment expenses and employee business expenses are deductible only as itemized deductions.

After computing adjusted gross income, an individual may deduct the excess of the sum of certain expenses incurred during the year over the standard deduction, now called the "zero bracket amount". Expenditures within this category generally are referred to as itemized deductions; they are deductible only to the extent that they exceed the zero bracket amount (formerly the standard deduction). As a result, individuals frequently are presented with the practical necessity of computing the total amount of their potentially deductible annual expenditures to determine whether those expenses exceed the zero bracket amount, and thus whether they should itemize. To make these calculations, taxpayers must maintain the applicable records for the taxable year. The existence of intricate rules and limitations with respect to the eligibility for and the computation of the various deductions which must be itemized led the Treasury Department to report, in 1973, that itemization of deductions "causes the greatest complication in the individual tax. . . ."[8]

Many proposals designed to simplify the individual income tax have focused on these provisions. In particular, changes have been suggested which would simplify tax return preparation, minimize the need for detailed record-keeping, and reduce computational difficulties. The achievement of these objectives would decrease return errors substantially, and thereby eliminate many of the burdens of audit review and verification currently imposed upon taxpayers and the Internal Revenue Service.

As noted above, itemized deductions allowed to individuals also include certain specified expenditures, incurred incident to employment or investment activities, which are ordinary and necessary expenses for the production of income. For example, they encompass such expenses as those incurred for union and professional association dues, job-related educational fees, and, in some instances, the cost of work clothes. Moreover, itemized deductions may include the cost of investment advisory services, subscriptions to financial publications, and tax planning and return preparation.

As noted above, individuals who itemize may deduct a number of expenditures which are not incurred for the production of income.

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[8] Department of the Treasury, Proposals for Tax Change, 106 (Apr. 30, 1973).

The principal items within this category are State and local taxes, charitable contributions, interest, medical expenses, and casualty losses.

The rationales or objectives generally cited as underlying particular itemized deductions include: achieving more equitable treatment of taxpayers by adjustments to reflect relative ability to pay taxes (deductions for medical expenses and casualty losses) ; stimulating or facilitating taxpayer expenditures for some social or economic purpose (deductions for home mortgage interest and property taxes, and for charitable contributions) ; refining the tax base to better measure taxable income (miscellaneous expense deduction) ; coordination of Federal, State, and local taxation impacts (deduction for State and local taxes, generally) ; or some combination of these factors. Therefore, to the extent that particular tax simplification proposals seek to eliminate or reduce the use of itemized deductions, the proposals may prevent the realization of these other objectives.

2. *Issues involved in the consideration of repeal or revision of itemized deductions*

In general, the basic issues previously mentioned concerning tax equity and the attainment of economic and social goals would arise in connection with any simplification proposal which involves the repeal or a significant restrictive change of an itemized deduction. The consideration of these issues would also include the possibility of reducing tax rates from the revenues which would be raised from repealing or restricting itemized deductions and the impact of such a reduction in attaining tax equity and social or economic goals.

One way to reduce the complexity associated with itemized deductions is to increase the standard deduction. As a result of changes to the standard deduction (presently called the zero bracket amount) made by the Tax Reduction and Simplification Act of 1977, it is estimated that some 6.7 million returns will shift from itemizing, reducing the percentage of itemizers from approximately 31 percent to about 24 percent.

A significant limitation on use of an increased standard deduction (or zero bracket amount) to simplify the preparation of tax returns is the revenue cost of further increases.

An alternative approach could involve reducing the number of taxpayers eligible to claim a particular itemized deduction by adding a deduction floor, or increasing any existing floor, so that only expenditures above the floor could be deducted. For example, fewer taxpayers would be eligible to itemize medical expenses if the deduction floor (now 3 percent of the adjusted gross income) were increased. To the extent that any such decrease in the amount of allowable medical expenses (or other items) would reduce a particular taxpayer's itemized deductions below the zero bracket amount, further simplification would result. However, some taxpayers who currently itemize medical expenses would still be required to keep receipts and make the computations in order to determine whether their expenses in a particular year exceeded the applicable floor, even though the year-end computation might show no deductible expenses.

The House Committee on Ways and Means applied the deduction-floor approach in reaching tentative decisions in late 1974 on tax reform proposals. Under the tentative committee decisions, the medical expense deduction floor was to be raised from 3 percent to 5 percent, the separate deduction for a portion of health insurance premiums was to be eliminated as well as the separate 1-percent floor for drugs and medicines, a 3-percent floor to the casualty loss deduction was to be added, and a $200 floor to the "miscellaneous expense" deduction was to be added. To offset the increase in tax liability which would result from these proposed limitations on itemized deductions, it was tentatively decided to add a "simplification deduction" (not to exceed $650) to be available to taxpayers who would continue to or then be eligible to benefit from itemizing notwithstanding these modifications. These tentative decisions were not, however, incorporated in any bill reported by the committee.

3. *Specific areas of complexity*

a. Medical expenses

In general, an individual may deduct unreimbursed medical and dental expenses in excess of 3 percent of adjusted gross income, plus one-half of medical insurance premiums (up to $150) without regard to the 3-percent floor. In 1975, medical deductions totaling $11.4 billion were claimed on approximately 19 million tax returns, or about 75 percent of those filed by itemizers. For fiscal 1977, the total reduction in revenues attributed to this deduction is estimated at $2.6 billion.

Before an individual who intends to claim a medical expense deduction can determine the amount deductible, he or she is presented with a "formidable hurdle,"[9] a three-step calculation. First, the taxpayer deducts one-half of any medical insurance cost up to a maximum of $150, regardless of the amount of adjusted gross income. Second, the taxpayer collects and totals all bills for medicine and drugs not compensated by insurance and then determines the amount by which these exceed one percent of adjusted gross income. Third, the taxpayer then determines the sum of the excess medicine and drug expenses, the remainder of any medical insurance cost not deductible under the first step, and the other medical expenses such as physicians' fees and hospital bills not compensated by insurance. The allowable medical deduction equals the excess of this total amount over 3 percent of adjusted gross income plus the medical insurance deduction computed under the first step. Any recomputation of a taxpayer's adjusted gross income on audit would require appropriate adjustments to the medical expense deduction.

Medical expense deductions have been allowed since 1942 on the rationale that "extraordinary" medical costs—those over a floor designed to exclude predictable, recurring expenses—reflect an economic hardship, beyond the taxpayer's control, which reduces the ability to pay taxes. The 1-percent floor on drugs is intended to serve as a rough way of excluding from the deduction calculation ordinary drugstore purchases such as aspirin and bandages. The special rule for insurance premiums has been justified on the ground that such premiums help even out health expenditures and make it less likely that such expenses can be deducted; consequently, it is argued, at least part of the cost of premiums should be outside the floor to avoid creating a disincentive for carrying health insurance. It might also be argued that, since employer contributions for health insurance are excludable from income by an employee (sec. 106), the special

[9] Dep't of the Treasury, Proposals for Tax Change, 108 (Apr. 30, 1973).

itemized deduction treatment for health insurance achieves some degree of equity between taxpayers who are not fortunate enough to be covered by an employer-financed program and those who are covered. However, the special treatment provides no equalizing benefit to taxpayers who do not itemize deductions.

Several proposals have been suggested for simplification of the medical expense deduction:

(*i*) The deduction floor could be raised to a higher percentage of adjusted gross income, thereby reducing the number of taxpayers eligible to deduct medical expenses. Assuming the higher percentage can be justified, this simplification change would be consistent with the underlying rationale of the floor—to limit the deduction to "extraordinary" medical expenses.

(*ii*) The separate floor for drugs and medicine, which introduces complexity into the deduction computation, could be eliminated. But in order to continue meeting the purpose of the current floor—barring the deduction for ordinary items such as headache remedies and cough drops—the statute should be amended to count medicine and drug expenses only for prescription drugs. (In 1974, the Ways and Means Committee tentatively decided to take this approach.) Such a simplification of the medical expense computation could give rise to some definitional complexity and possible distinctions without a real difference, e.g., insulin obtainable without a prescription would be deductible only if prescribed by a physician.

(*iii*) The special rule for partial deduction outside the floor for medical insurance premiums could be eliminated to reduce computational problems. In the alternative, the full premium could be allowed as a separate deduction entirely outside the medical expense floor. However, such an alternative would result in a substantial revenue loss.

Any sizable reduction in the number of medical expense itemizers would lessen the audit burden of the Internal Revenue Service and the taxpayer burdens of verifying and substantiating large numbers of expenditure items. In addition, the volume of audit and litigation controversies concerning this deduction presumably would be reduced. Numerous issues (apart from substantiation) have arisen as to the medical expense deduction, including the deductibility of the following types of expenses: various travel and transportation expenses incident to medical treatment; schooling expenditures for children with handicaps or impairments; domestic help or nursing costs for ill persons; capital expenditures (such as air conditioners or elevators) for persons with medical problems; the deductibility of expenditures on behalf of dependents; and the definition of medical care expenses (acupuncture, vasectomies, vitamins, birth control pills, etc.).

The 1973 Treasury simplification proposals recommended that medical and casualty losses be aggregated as a single itemized deduction subject to a 5-percent of adjusted gross income floor. The aggregation could be justified on the grounds that both types of items are extraordinary in nature. This approach would contribute toward simplification by eliminating a separate floor computation for casualty losses. The itemized deduction schedule for individuals would be revised by the elimination of the separate section for casualty losses. However, many of the reporting requirements for the separate casualty loss section would merely be shifted to a new section for the aggregate medical and casualty deduction.

b. Casualty losses

Since the inception of the income tax laws, individuals have been permitted to deduct losses incurred with regard to personal property caused by fire, theft, or other casualties, but only to the extent not covered by insurance. A further limitation allows such losses only to the extent they exceed $100 for each occurrence. While these losses do not necessarily represent out-of-pocket expenditures, the deduction is premised on the theory that the casualty victim must use income to replace the damaged property, thereby reducing ability to pay taxes in the same manner as would catastrophe-type medical expenses. The $100 floor, added to the statute in 1964, serves not only to exclude predictable, ordinary losses but also to eliminate what might be a multitude of hard-to-audit small claims (e.g., a claim of $35 damage to shrubbery from a rainstorm).

Some 1,765,000 returns for 1975, or about 7 percent of the returns filed by itemizers, claimed casualty losses aggregating $1.2 billion. The total reduction in revenues attributable to this deduction has been estimated at $345 million for fiscal 1977. (The deduction for personal casualty losses is identified as an issue generating significant controversy between section III of the report.)

Under the 1974 tentative decisions of the Ways and Means Committee, there would have been two floors on the casualty loss deduction—$50 per occurrence (reduced from the present $100 limit), plus a floor of 3 percent of adjusted gross income applicable to the aggregate excess over the per-occurrence limit. While this change would have increased computational complexity for taxpayers who could still itemize casualty losses, it would have achieved simplification by reducing the number of taxpayers claiming such deductions. This change would have eased audit burdens for the Internal Revenue Service and reduced the significant volume of audit and litigated disputes over the types of casualties giving rise to deductible losses, computation of the deductible amount, proof of losses, etc.

c. Miscellaneous expenses

As stated above, itemized deductions include certain employee or investor expenses incurred in earning income. The allowance of this deduction, it is argued, creates difficulty for those taxpayers who must keep track of numerous, relatively small expenditures throughout the year. The 1974 tentative decision of the Ways and Means Committee would have placed a $200 floor under the miscellaneous expense deduction. Thus, taxpayers who customarily did not incur expenses of that size, and who did not expect to incur expenses in the coming year exceeding $200, might have decided not to bother keeping records during the year or computing the amount for purposes of the tax return. Also, the floor would have relieved audit verification and substantiation burdens for individuals claiming small amounts for such expenses.

d. State and local gasoline taxes

Under present law, a taxpayer's itemized deductions include State and local taxes imposed on gasoline, diesel fuel, and other motor fuels which are used for nonbusiness purposes. The taxpayer may rely on records to establish the exact amount of such tax expenditures or may calculate the amount deductible from tables printed in the tax return instructions.

This deduction was claimed on about 26,500,000 returns for 1973, or approximately 95 percent of the returns filed by itemizers. The aggregate of the amounts deducted was $2.8 billion. The total reduction in tax revenues attributable to this deduction is estimated at $699 million for fiscal 1977.

The Service has prescribed tables for determining the deductible amount based on mileage and the rate of tax. Although the determination of mileage may involve record-keeping and present difficult audit problems, the actual calculation of the deduction from the tables would not seem unduly complicated for most taxpayers. By contrast, use of the sales tax deduction table requires more computational complexity for taxpayers with gross income above $20,000. Reasons other than simplification also have been suggested for elimination of the gasoline tax deduction. In 1974, the Ways and Means Committee tentatively decided to eliminate this deduction, as well as deductions for certain other miscellaneous taxes. The National Energy Act (H.R. 8444), as passed by the House of Representatives on August 5, 1977, also would repeal the gasoline tax deduction (based in part on energy conservation reasons).

e. Charitable contributions

Within certain limitations, an individual may deduct contributions of cash or property to qualified charities. The charitable deduction, allowed since 1917, serves as an incentive for charitable giving. The deduction has been said to be justified because charitable activity relieves the burdens of government and, since charitable contributions do not represent revenue used for personal consumption or increasing personal wealth, they should be excluded from the tax base.

On some 24,635,000 returns for 1975, or about 95 percent of the returns filed by itemizers, deductions for charitable contributions amounting to $15.4 billion were claimed. The total reduction in revenues attributable to this deduction for individuals has been estimated at $5.44 billion for fiscal 1977.

Some of the complexity factors cited to justify eliminating or curtailing use of other itemized deductions would appear applicable to the charitable contributions deduction as well. The availability of the deduction to all itemizers, without a limiting percentage or dollar floor, requires taxpayers to maintain careful records throughout the year of all gifts, regardless of size. In the case of cash contributions (not paid by check) to religious institutions or to groups soliciting door-to-door, however, taxpayers may often neglect to obtain receipts or keep track of amounts given. Consequently, in preparing their returns the donors may either forego or overlook deductions to which they are entitled or may estimate the total amounts. Valuation difficulties frequently occur with respect to contributions which entitle the donor to some privilege or benefit, such as payments for fund-raising entertainment events, and with respect to contributions of property, such as gifts of used clothing or appliances to community groups. On audit, the taxpayer may face significant substantiation burdens.

In "Tax Reform Studies and Proposals" published in February 1969 (developed under the Johnson administration), the Department of the Treasury recommended adoption of a deduction floor of 3 percent of adjusted gross income, with any excess deductible whether the taxpayer utilized the standard deduction or itemized other deductions. This change was intended to maintain the existing tax incentive for more than routine private giving, while achieving simplification by reducing the number of taxpayers claiming the deduction and requiring auditing. However, neither the "Tax Reform Studies and Proposals" nor the Treasury's 1973 "Proposals for Tax Change" proposed a charitable deduction floor.

The charitable deduction provisions have given rise to numerous audit and litigation controversies, even with respect to cash contributions (e.g., issues as to the deductible amount of payments to a charity, qualified donees, form of contribution, percentage limitations, and substantiation). The statutory and regulatory provisions relating to nontrust gifts of appreciated property are among the most intricate in the Code.

Considerable complexities may be involved in the determination of the amount deductible for charitable contributions of property. The general rule is that the amount deductible is the fair market value on the date of contribution. However, special rules in some cases (most cases for individual contributors) require that the value of the property be reduced by any amount which would be treated as ordinary income if the property were sold on the date of contribution. Also, in the case of some property contributed to private foundations, the amount of the contribution may have to be reduced by a portion of the appreciation which would be treated as capital gains. The amount deductible depends upon (1) the classification of the property as ordinary income property or as capital gain property, (2) the status of the donee as either a public charity, a private operating foundation, or a private nonoperating foundation which will "pass through" the contribution within a specified time, (3) the status of the donor (since corporations are, in some cases, entitled to more favorable treatment than individuals), and (4) if tangible personal property is contributed, whether the donee organization will use the property directly in connection with its exempt function. The percentage-of-income limitations and the carryover rules increase the complexity of the provision.

The rules applicable to contributions of appreciated property were adopted as part of the Tax Reform Act of 1969, to preclude the possibility that a donor could obtain a greater benefit financially from giving away property rather than selling it. It is arguable that the same objective could have been met by adoption of a far simpler rule which would limit the deduction for appreciated property to the lower of the property's adjusted basis or its fair market value.

Among the rules designed to prevent abuse of the charitable contributions deductions are certain percentage-of-income limitations. There is one overall percentage limitation and two special limitations. One of these special limitations involves contributions to private foundations, and the other involves contributions of appreciated property. Although these limitations do not apply to many taxpayers, when they do apply the interaction can result in substantial complexity.

E. Tax Credits

1. In general

There are several major categories of credits against income tax liability. One category includes credits to reflect prepayments of income tax. This category includes the credit for income tax withheld from wages (sec. 31(a)) and the credit for tax withheld at the source on certain payments to nonresident aliens (sec. 32). A second category includes credits used to refund overpayments of taxes other than income taxes. This category includes the credit for the overpayment of an employee's social security taxes (sec. 31(b)) and the credit of overpayments of excise taxes on gasoline and other fuel which has been used for an exempt purpose (or for off-highway purposes, with respect to which the special fuels tax applies at a reduced rate). These two categories of credit are fully refundable to the taxpayer, i.e., they may be claimed even if they exceed the taxpayer's income tax liability.

A third category consists of the credit for the income tax imposed on foreign source income by foreign countries or the Possessions. The purpose of the credit is to eliminate taxation of income by two countries.

A fourth category consists of credits designed as incentives to achieve certain social and economic objectives. This category includes the general tax credit (added in 1975 for economic stimulation), the investment tax credit, the jobs tax credit, the work incentive credit, the earned income credit, the child care credit, the credit for the elderly, and the credit for contributions to political candidates. Except for the earned income credit, these credits are nonrefundable, i.e., they cannot exceed the income tax liability of the taxpayer. The investment credit and the work incentive credit are further limited to a portion of the taxpayer's tax liability. Carryback and carryover rules are provided for some credits which are unused as a result of the limitations.

The credits in this last category are more diverse than any other category. Most of the credits added in the last 10 years have been in this category.

2. Issues involved in repeal or revision

The credits for tax prepayments are necessary for the accurate computation of the unpaid tax liability. As a result, they cannot be eliminated.

The possible repeal of the credits designed to refund overpayments of nonincome taxes raises fundamental questions concerning the rationale for treating these amounts as overpayments. In the case of the credit for excess FICA tax withheld for an employee with more than one employer, the basic issue concerns the maximum annual FICA tax to be paid by an employee. Since FICA benefits are not increased by excess contributions, imposing a greater tax on an employee who earns, in the aggregate, more than the maximum wage base from two or more sources than that which is imposed on an employee who earns the same amount from a single employer raises serious questions of horizontal equity. In the absence of a viable alternative through which the tax treatment accorded to such similarly situated taxpayers could be equated, equity considerations would preclude the repeal of this type of credit.

The credit for excise taxes for nontaxable (or partially taxable) uses of gasoline and other special fuels is based on the rationale that these taxes are user charges. Since the funds raised by these taxes are earmarked for the construction of highways, the consumption of a taxable fuel in a nonhighway use should not be taxed because no benefit is derived from the use of highways. In substance, the issue in repealing this credit involves equity consideration because of the benefit rationale underlying the tax. Another issue concerning this credit involves the effect, if any, that the refund of the fuels taxes for exempt purposes has on energy conservation. This issue would involve a review of all of the underlying exemptions for which a credit is allowed, e.g., farming uses, local transit uses, etc. In this context, the nontaxable uses affecting the average taxpayer could be separated from trade or business nontaxable uses. In the case of the average taxpayer, the nontaxable uses most often involved are fuels consumed by lawn mowers and recreational boats. In the typical case, the amounts of credit involved for these uses are insignificant. Thus, a strong simplification argument can be made for eliminating the credit for these uses.

For both the excess FICA credit and the excise tax credit, another issue is whether the use of credits under the income tax system is the most efficient way of providing refunds for overpayments. Under present law, a separate claim for refund for the fuel taxes can be made in the case of (1) farm use, (2) governmental units or tax-exempt organizations, or (3) where the amounts exceed $1,000 during the first three-quarters of a taxpayer's taxable year. Otherwise, a credit must be claimed on the income tax return. But for these restrictions, the number of claims filed for small amounts would be substantially increased. In the case of excess FICA payments, providing an alternative means of claiming a refund would also increase the paperwork involved.

The complexity of the foreign tax credit is attributable to (1) the option to credit or deduct foreign taxes, (2) the limitation of the credit to the amount of U.S. tax on foreign income, (3) the source rules, (4) limitations on the type of creditable taxes, (5) carryover provisions, and (6) other limitations. In considering repeal of the foreign tax credit, the basic issues would involve equity, foreign policy and trade questions. The equity considerations basically involve potential double taxation of the same income.

The complexities of the foreign tax credit do not directly affect most taxpayers in the preparation of their returns but rather affect a small class of taxpayers.[10]

The credits designed to provide social and economic incentives raise the basic issues concerning equity and economic and social objectives. However, a number of equity issues are unique to the credit provisions. First, an argument is made that a credit is more equitable than a deduction because the same tax benefit is provided for all taxpayers regardless of amount of income, while a deduction provides greater benefits to upper income taxpayers due to the graduated rate schedules. Second, an argument is made that a credit for social and economic purposes is more equitable (and efficient) because it is available to all taxpayers including those who do not itemize deductions. The contrary argument in the case of an item with wide application is that progressivity should be a function of the rate schedule, and if the item truly represents a reduction in ability to pay, a credit instead of a deduction unfairly increases progressivity. In addition, the desirability of using income tax credits, like using deductions or exclusions, depends on a resolution of the basic issue of whether it is more appropriate to use the tax system or direct appropriations to provide financial aid or incentives for certain purposes. In this regard, the principal questions relate to efficiency, the necessity for periodic review of the effects of incentives, and jurisdiction of the various Congressional committees. (Since the earned income credit is refundable, the interrelationship of tax credits and the appropriations system is of greater significance for this credit.)

The credits which cause complexity for the average taxpayer are in this social and economic incentive category. While the general tax credit has now been built into the tax tables thereby removing it as a concern for almost all taxpayers, the credits for earned income, the elderly, child care, and political contributions, along with the expired new home tax credit, are major causes of taxpayer confusion and tax return error. Any or all of these credits could be repealed, but only at the cost of reversing a policy decision to favor the affected groups. Several credits could be simplified either by removing limits or restrictions which limit the revenue cost of the provisions or by eliminating refinements which fine-tune the provisions but increase complexity.

3. Specific areas of complexity

a. Earned income credit

Low-income families are eligible for a refundable credit equal to 10 percent of the first $4,000 earned income, with a phaseout for families with incomes between $4,000 and $8,000. Generally, the purposes of the earned income credit are to eliminate economic advantages tax-free welfare may have over low-paid work and to provide relief for

[10] The individuals who are directly affected by the foreign tax credit are, for the most part, individuals employed abroad who are eligible to exclude a portion of the income earned abroad from income subject to United States tax. For these indivduals, calculations of the allowable foreign tax credit may present some computation difficulties because the income exclusion provision requires that the portion of the foreign taxes attributable to excluded income not be treated as creditable taxes.

social security taxes imposed on the wages of low-income families. The phaseout is designed to restrict the benefits of the credit to those taxpayers who need relief the most.

For taxpayers with income of $4,000 or less, the earned income credit is computed by multiplying earned income by 10 percent. For taxpayers with earned income or adjusted gross income between $4,000 and $8,000, the credit is computed by subtracting from $400 the product of 10 percent of the excess of either earned income or adjusted gross income (whichever is greater), over $4,000. This credit was intended to improve the financial position of lower income working families, especially vis-a-vis families on welfare. It also is seen by some as a means of alleviating the burden of payroll taxes in this income range.

One way to simplify the earned income credit with only minor modification to its basic structure would be to have it determined on amounts which already are listed on the individual income tax return, i.e., "earned income" is not separately shown on the return. If this were done, the credit would be easier to compute, and the Service could treat errors in computing it and failure to claim it as math errors. Another way to simplify the credit would be to link the phaseout to earned income or to adjusted gross income but not to both.

b. Credit for the elderly

The Tax Reform Act of 1976 converted the former retirement income credit into a credit for the elderly. The new credit is much less complex than its predecessor, which originally was intended to treat taxpayers who received little or no social security benefits about the same as those receiving tax-exempt social security benefits. The former credit was very complex because it was patterned after the requirements of the social security law.

The new credit is more generally available to taxpayers age 65 or over, who are allowed a credit of 15 percent of a limited amount of their income reduced by social security benefits and certain other tax-exempt income. The income limits are $2,500 for single taxpayers and $3,750 for joint returns where both spouses are age 65 or older. The credit is phased out for single taxpayers with adjusted gross income between $7,500 and $12,500 and for married taxpayers with adjusted gross income between $10,000 and $15,000 ($17,500 if both spouses are age 65 or over). Thus the credit is available for all taxpayers age 65 or over, regardless of the type of income they receive. However, that eligible income must be reduced by the amount of social security benefits and certain other tax-exempt income received. The credit is phased out for higher-income taxpayers. The phase-out focuses relief on low- and middle-income taxpayers.

Taxpayers under age 65 who are retirees under a public retirement system also were eligible for the former retirement income credit, but only for income from a qualified governmental retirement system. Under the new credit, they remain eligible for a somewhat simplified version of the former credit until they reach age 65. This provision requires the reduction of eligible income by the amount of earned income received over a floor amount. An election between this credit and the credit for the elderly over age 65 must be made in the case of joint returns with one spouse under age 65 and one age 65 or over.

The repeal of this credit for taxpayers under age 65 would simplify the law. However, tax equity issues would arise, i.e., government employees who retire before age 65 should be given the same treatment as private sector employees who retire at age 65 or over.

c. Credit for household and dependent care services

The Tax Reform Act of 1976 replaced the itemized deduction for household and dependent care expenses with a nonrefundable tax credit. The credit is allowed for 20 percent of expenses paid for the care of either a child under age 15 or an incapacitated dependent spouse, in order to enable the taxpayer to work. The credit is allowed for expenses up to a maximum of $2,000 for one dependent or $4,000 for two or more dependents. This amount, however, may not exceed the earnings of the spouse earning the lesser amount. This limitation reflects the fact that child care expenses are ordinarily incurred to enable the second earner in a family to be gainfully employed. A special rule is provided for a spouse who is a full-time student.

The computational requirements of this provision are less burdensome than they were under prior law, although records of expenses must still be maintained and a separate tax form filed. There still are difficulties with some of the definitional requirements. While some argue that this provision could be repealed on the theory that child-care costs are merely personal consumption items and no more a cost of producing income than are such nondeductible items as commuting expenses, this credit is widely seen as a method of reducing the tax burden of two earner and single parent families.

d. Credit for political contributions

A nonrefundable 50-percent credit is allowed for contributions made by individuals to political candidates for nomination or election to any Federal, State, or local public elective office, to political parties, or to newsletter funds of public officials. The credit is limited to $25 ($50 in the case of joint returns) and is allowed only if the contribution is verified. In lieu of the credit for one-half of his political contribution of up to $50, an individual may elect to take an itemized deduction for contributions of up to $100 ($200 for joint returns).

The computation of the political credit is relatively simple, and the only administrative problem is verification that the contribution went to an eligible recipient. The election between a credit and an itemized deduction, however, is confusing to taxpayers. Repeal of the deduction would eliminate this complexity.

F. Capital Gains and Losses

1. Introduction

In considering the treatment of capital gains and losses, the following discussion emphasizes simplification issues. If repeal of these provisions were considered, a number of other important issues would arise—including the effect on capital formation and mobility, the effect of inflation on gains, the problem of applying graduated tax rates to realized gains "bunched" in a single taxable year, the possibility of integrating the corporate and individual income taxes. With its emphasis on simplification, this report is not intended to provide definitive answers to these other important tax policy questions. Some of the related issues are discussed for the purpose of describing the complexity that might result from possible solutions. The discussion should *not* be taken as a recommendation for or against repeal of capital gains treatment or for solutions for the various problems which would arise if it were repealed.

2. Present law

Gain or loss from the sale or exchange of certain types of property is treated differently than income from services, sales of property held for sale in the normal course of business, and other routine activities. In general, long-term capital gains are taxed at a lower rate than other types of income. In the case of individuals, the tax is the lesser of (1) the regular tax on one-half of such gains, or (2) an alternative tax of 25 percent for the first $50,000 in gains for a year and the regular rate on one-half of gains in excess of that amount. In the case of corporations, the tax is the lesser of 30 percent of the gains or the regular corporate tax (presently the rates range from 20 percent to 48 percent).

The precise reasons for treating capital gain or loss differently than other gain, loss, or income are not always made clear in the legislative history. However, the traditional arguments in favor of a different treatment include the following: (1) the sale or exchange of a capital asset usually involves only a change in the form of the taxpayer's investment; (2) gain or loss essentially is a reflection of the price structure (i.e., gain really represents the effects of inflation and therefore is illusory); (3) generally, gain which has accrued over a substantial time period should not be subjected to the progressive tax rates in the year in which it is realized because a greater tax will tend to immobilize capital. Additional arguments are made in favor of different treatment for capital gains. One of these arguments is that different treatment should be provided for capital gains as an incentive for risk-taking investment.

The type of property which may give rise to capital gain or loss is referred to as a "capital asset" which is defined to include all classes of property that are not specifically excluded. Under these provisions, the following items are *not* treated as capital assets: (1) inventory, stock in trade, and property held primarily for sale to customers; (2) depreciable property and real property used in a trade or business; (3) copyright, literary, or similar property held by its creator, or by his transferee in a tax-free transaction; (4) accounts or notes receivable acquired in a trade or business; (5) certain governmental obligations; and (6) government publications received without charge or at a reduced price.

Under special rules, capital gains treatment is also extended to sales or exchanges of certain other property. These special rules extend capital gains treatment to: (1) depreciable and real property used in a trade or business; (2) timber, coal, or domestic iron ore; and (3) certain breeding livestock (sec. 1231). On the other hand, many provisions deny capital gains treatment for certain transactions or recapture a portion of a gain as ordinary income. These provisions include the special rules for sales and exchanges of depreciable property between related taxpayers (sec. 1239) and the depreciation recapture rules (secs. 1245 and 1250). In addition, there are a number of income characterization provisions designed to prevent the conversion of ordinary income into capital gains (e.g., secs. 306, 341, 1232).

In general, gain or loss from the sale or exchange of a capital asset is "capital gain" that may qualify for special tax treatment, or "capital loss" that may be subject to restrictions on deductibility. Whether gain or loss falls within the special rules covering capital assets ordinarily depends on whether it arises in a transaction (1) involving a "sale or exchange" (2) of a "capital asset" (3) that has been "held by the taxpayer."

Capital gains and losses are classified as long-term or short-term depending upon the holding period of the asset. In general, long-term capital gain or loss results from the sale or exchange of property which has been held for more than nine months, and short-term gain or loss results from the sale or exchange of property which has been held for nine months or less.[11] Beginning in 1978, property must have been held for more than 12 months to qualify for long-term treatment.

If net long-term capital gains exceed net short-term capital losses, an individual taxpayer may deduct 50 percent of the excess from gross income. As a result, the deduction has the same effect as applying one-half the taxpayer's highest marginal rate to the entire gain. Generally, therefore, the highest rate at which long-term capital gains will be taxed is 35 percent, i.e., one-half the maximum tax rate of 70 percent. The only instances in which maximum rate may exceed 35 percent result from the application of the minimum tax or the maximum tax

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[11] The general holding period requirement for classification as long-term capital gain or loss was changed from 6 months to 9 months (for taxable years beginning after December 31, 1976) by the Tax Reform Act of 1976.

There are exceptions to the general holding period requirement. For example, the holding period is 6 months for commodity futures contracts. Also, in order to obtain long-term capital gain treatment, the holding period is 24 months for cattle and horses held for draft, breeding, dairy, or sporting purposes, and 12 months for other livestock (not including poultry) held for these purposes (sec. 1231(b)(3)).

on earned income which can raise the effective rate on capital gains to as much as 49.125 percent.[12]

In lieu of taxing 50 percent of long-term capital gains at the regular rates, an alternative tax applies if it results in a lower tax than that produced by the normal method. The alternative tax consists of a 25-percent tax on the first $50,000 of net long-term capital gain. Therefore, the alternative tax benefits only those individuals whose income is subject to marginal rates exceeding 50 percent.[13] The alternative tax will never save more than $5,000 for a taxpayer in a taxable year.

If a taxpayer has only a net long-term capital loss, the loss may offset up to $3,000 of ordinary income but two dollars of loss is required to offset one dollar of income. This two-to-one ratio for long-term losses to ordinary income, which was enacted in 1969, is intended to complement the special treatment accorded to long-term capital gains whereby two dollars of gains are taxed like one dollar of ordinary income. A net long-term capital loss in excess of the amount of loss used to offset ordinary income becomes a long-term capital loss carryover. If the taxpayer has only a net short-term capital loss, however, up to $3,000 of that loss may be applied in full against ordinary income; any excess becomes a short-term capital loss carryover to future years. There is no limit to the number of years to which an individual's excess capital losses may be carried forward, but they may not be carried back to a prior year.

For corporations, the alternative tax is 30 percent of the excess of net long-term capital gain over net short-term capital loss. However, the alternative tax will not benefit a corporation if the gain is subject only to the normal corporate rate (which is less than 30 percent)

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[12] This is the sum of a 35-percent regular tax, a tax increase on earned income equal to 10 percent of the capital gain, and a 4.125-percent minimum tax (this is the effective rate of the minimum tax after giving effect to the deduction for regular taxes). (In certain very unusual circumstances, the rate of tax on a capital gain can be as high as 52.5 percent, i.e., where due to various tax credits the minimum tax exemption is not increased by the income tax on the capital gains.)

[13] The alternative tax is the sum of three "partial" taxes. First, a partial tax must be computed at the regular rates on taxable income reduced by 50 percent of the taxpayer's net long-term capital gain in excess of net short-term capital loss. Since 50 percent of the net long-term capital gain was initially deducted in arriving at taxable income, this further reduction removes the full amount of long-term gain in computing the tax base for the first partial tax, i.e., the first partial tax is based solely on the taxpayer's ordinary income.

The second partial tax is 25 percent of the lesser of $50,000 or the net long-term capital gain. Therefore, the second partial tax is a flat 25 percent of the first $50,000 of net long-term capital gain.

If the net long-term capital gain exceeds $50,000, the third partial tax applies. The third partial tax is an amount equal to the difference between (1) the tax computed at normal rates on taxable income, including 50 percent of the net long-term capital gain, and (2) the amount of the tax computed at normal rates on the sum of all taxable ordinary income and 50 percent of long-term gain up to $50,000 ($25,000 in the case of married individuals filing separately).

Once the sum of the three partial taxes is determined, the taxpayer pays the lower of this amount—the "alternative tax"—or the regular tax. The alternative tax will not be lower than the regular tax unless the taxpayer's marginal tax rate under the regular rate schedule is more than 50 percent.

rather than the combined normal and surtax rate of 48 percent. The alternative tax applies only to net long-term gains; net short-term gains are taxed at ordinary rates. No deduction for 50 percent of a long-term capital gain is provided for corporate taxpayers.

Corporations may offset capital losses only against capital gains. Corporate capital losses can be carried back three years, and carried forward five years. Losses must be carried back to the earliest year allowable, and then carried forward until the losses are used or the five-year period expires.

3. Complicating features of capital gains treatment

It has been said that capital gains treatment is "perhaps the single most complicating aspect of existing law." [14] There are the obvious computational complexities mentioned in the preceding discussion. The complexities are also reflected in the applicable income tax forms.[15]

Many of the complexities are attributable to definitional problems and to the significant number of special rules adopted to prevent abuse of the special treatment for capital gains.

As previously noted, capital gains or losses ordinarily result from the sale or exchange of a capital asset. However, capital gains or losses may result from an event which does not constitute a sale or exchange.

Further, capital gains treatment may be available for the disposition of property which is excluded from the capital asset definition. For example, if the taxpayer's aggregate transactions in depreciable and certain other property used in a trade or business for the year result in a net gain, each of those transactions is treated as involving a capital asset, with the net gain being treated as a capital gain (sec. 1231). Conversely, if the overall result is a loss, each transaction is treated as involving noncapital assets, with the net loss being treated as an ordinary loss. Thus, the Code allows gain from these assets to be taxed at the preferential capital gains rates, although a net loss from these assets is classified as ordinary, and deductible from ordinary income in full.

Moreover, there are instances when the sale or exchange of a capital asset does not result in capital gain or loss, but rather in ordinary income. For example, if a sale or exchange occurs between related parties, gains may be classified as ordinary, and losses denied.

Finally, there is a well-established judicial rule which denies capital gain treatment to sales or exchanges of property, which is not specifically excluded from the capital asset definition, but the income or loss from which is integrally related to "ordinary-income activities." As a result, whether a gain or loss is capital or ordinary depends

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[14] Panel Discussions on the Subject of General Tax Reform Before the Committee on Ways and Means, 93d Cong., 1st Sess. (pt. I) 118. (Statement of Boris Bittker.)

[15] The Schedule D of Form 1040, on which an individual computes the net short-term or net long-term capital gain or loss, contains 29 separate lines on two pages. Form 4798, which deals exclusively with carryovers of pre-1970 capital losses, is 4 pages long. Seventeen of the 34 lines on Form 4726, dealing with the maximum tax on personal service income, concern capital gains. The two-page minimum tax form also may have to be completed and filed. In addition to these forms, taxpayers having substantial long-term capital gains may have to use the income averaging forms. Regardless of whether averaging is elected, the taxpayer potentially is faced with the problems and computations presented by each of these forms and schedules.

not only on satisfying the general statutory prerequisites, but also on avoiding the broad exceptions carved into those requirements.

In many cases, taxpayers have little problem in determining whether the sale or exchange of their property will result in a capital gain or loss. So long as the property and its disposition meet the statutory requirements, without falling into one of the exceptions, the gain or loss realized will be merely a question of amount and not of character. However, in many other cases, considerable uncertainty exists as to whether an asset is a capital asset. The uncertainty has led to a substantial amount of litigation. Nevertheless, the issue is factual and requires case-by-case determination.

Indeed, it is the combination of the preferential tax rate with definitional uncertainty that has resulted in "[t]he concept of capital gains [being] constantly strained—even perverted—by devious manipulations to bring ordinary income under the tax definition of capital gains." [16]

As noted above, the Internal Revenue Code defines a capital asset simply as "property" held by the taxpayer, then lists several exceptions. Consequently, in innumerable instances taxpayers and their advisors have attempted to structure transactions to avoid the capital asset exceptions and to bring the transaction within the more favorable capital asset provisions. As a result, the Service and the courts have tended to interpret the exceptions broadly, except where the taxpayer seeks to obtain ordinary—rather than capital—loss treatment for transactions that fall within the statute since ordinary losses are fully deductible. The resulting tension has led to a maze of complex rules, as well as to inconsistent and irreconcilable decisions.

For example, inventory and property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business are excluded from the definition of a capital asset. The object of this exclusion is to preclude capital gains treatment for receipts obtained in the routine conduct of the taxpayer's enterprises. If the sale is of over-the-counter merchandise, there should be no doubt that the receipts are ordinary income. However, questions have arisen as to the appropriate treatment to be given to a bulk sale of inventory or stock in trade, and to liquidating distributions of inventory by corporations to their shareholders.

In addition, a host of cases have been litigated over whether gain received by the taxpayer was attributable to the sale of property held *primarily* for sale to customers in the ordinary course of the taxpayer's trade or business. The majority of these cases have involved real estate sales, and the sale of equipment held for rental (or for rental and then sale). In both instances, the litigation generally revolves around the question of the "primary" purpose for which the property was held. The resolution of this question, in turn, has generated an intricate web of subordinate rules and exceptions (relating to the existence of business (ordinary income) and investment (capital gain)

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[16] Hearings before the Senate Finance Subcommittee on Taxation and Debt Management, 95th Cong., 1st Sess. (June 13, 1977) (Testimony of Dan Throop Smith).

purposes,[17] and the acquisition of property for one purpose and its disposition for another.

Each of the other statutory exceptions to the capital asset definition has led to similar efforts to bring excluded activities and property into the scope of the generalized meaning of a capital asset. Some of the most questionable of these attempts have involved the sale of contract rights, and the doctrine of "collapsed anticipation of future income," which essentially holds that the taxpayer cannot sell the right to future income (as opposed to the right to make income in the future) as "property" that is a capital asset. Naturally, these issues, too, have generated a large number of rules and exceptions.

In addition to the complications which may arise incident to the explicit statutory exceptions, judicial exceptions further confound the intricacies of the capital asset rules. For example, in *Corn Products Refining Co.* v. *Commissioner*, the Supreme Court held that property otherwise within the definition of a capital asset may have such an important and integral relationship to the ordinary conduct of the taxpayer's business that it loses its identity as a capital asset.[18] However, some courts have held that certain losses were capital losses where the taxpayer acquired property predominantly for business purposes while also having substantial, but subsidiary, investment purposes.[19] Where the *Corn Products* doctrine is invoked, courts are presented with the question of whether the taxpayer acquired and held the property with a predominant business, as opposed to an investment, purpose. If the business purpose is found to be predominant, gain or loss is ordinary; conversely, a predominant investment purpose will cause gain or loss to be capital. Of course, it would be to the taxpayer's advantage to have gains characterized as capital, and losses as ordinary. Other characterization rules developed by the courts include the application of the tax benefit rule [20] and the *Arrowsmith* [21] doctrine under which earlier transactions are reviewed to characterize a current receipt or expense.

Some of the other problems in capital gains taxation, most of which have been dealt with by specific Code provisions, include those relating to disguised interest income (e.g., where the sales price or face amount of an obligation is inflated to reflect an unstated interest component), options to buy or sell, gain or loss on sales or exchanges between related parties, the correlation of prior events with present transactions, and the allocation of receipts between ordinary income and capital gain on the sale of a business. Each of these areas has resulted in technical rules and exceptions which add to the complexity of the law, while placing a premium on tax gamesmanship and creating a trap for the unwary. Correspondingly, they have tended to result in arti-

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[17] *See Scheuber v. Comm'r.*, 371 F. 2d 996 (7th Cir. 1967) ; *cf. Malat v. Riddell*, 383 U.S. 569 (1966). In *Goodman v. United States*, 390 F. 2d 915 (Ct. Cl. 1968), the court noted that, "[t]here is no one formula for determining whether property is held for sale or investment. Each case presents its own unique set of facts, all of which must be considered. . . ."

[18] 350 U.S. 46 (1955).

[19] *See, e.g., W.W. Windle Co.*, 65 T.C. 694 (1976), *aff'd on other grounds*, 550 F.2d 43 (1st Cir. 1977).

[20] *Comm'r* v. *Anders*, 414 F.2d 1283 (10th Cir. 1969).

[21] *Arrowsmith* v. *Comm'r* 344 U.S. 6 (1952).

ficially cast transactions which frequently elevate form above substance.

The depreciation recapture provisions have contributed to the complexity of the tax system. These rules establish an elaborate network through which gain that otherwise would be characterized as capital gain is deemed to be ordinary income under prescribed statutory formulae. Since the recapture rules apply to virtually all depreciable property, although in varying degrees, they add complexity to both tax planning and preparation of returns.

Although it appears to be a straightforward question, the determination of what constitutes a sale or exchange for capital gains purposes has generated a significant amount of litigation. Courts have been faced with the task of distinguishing between sales and gifts, sales and leases, sales and licenses (including the special statutory provisions covering patent and franchise transfer), and sales and loans, as well as classifying "bootstrap sales," deferred payment and installment sales, and sales and leasebacks. In addition, the courts have had to interpret the numerous statutory sale or exchange provisions, i.e., those Code sections which treat certain non-sales or exchanges as sales or exchanges. These provisions deal with such topics as bad debts and worthless securities, stock redemptions, corporate liquidations, deficit distributions, bond retirements, involuntary conversions, options, lease cancellations, and transfers of franchise, mineral, patent, and timber interests. The resolution of any issue concerning any of these provisions inevitably requires a determination of whether the threshold requirements for the statute's application have been met.

The coordination of the capital gains preference with the minimum and maximum tax provisions has contributed to complexity. (These provisions are described below.) In the case of the minimum tax, one-half of net long-term capital gain is treated as a tax preference. In a substantial number of cases, the tax applies solely because of the capital gains preference. In addition, the maximum tax on earned income is complicated because the capital gains preference is taken into account in determining benefits available under the maximum tax.

4. Issues involved in repeal or revision

In considering the repeal or significant contraction of the capital gain rules, a number of basic issues would arise concerning equity and social or economic incentives. There are equitable considerations for and against repeal. On the one hand, repeal of the preferential treatment would further the concept of horizontal equity. Repeal could also be supported on vertical equity, or ability-to-pay principles. On the other hand, it may be argued that it is inequitable to fully tax inflation-induced gains, i.e., gains accrued over a long period of time are basically different than the usual forms of current cash income, such as wages, in terms of purchasing power because of the erosion attributable to inflation occurring over the holding period. In addition, it might be argued that it is inequitable to subject gains, which have accrued over a long period of time but are "bunched" in a single year in which realized, to a progressive tax, and adequate mitigation is not provided through averaging mechanisms.

The consideration of repeal of the capital gains treatment would also raise several issues relating to economic effects. One issue concerns the effect repeal of the special treatment would have on capital formation. Another issue concerns the effect repeal would have on the mobility of capital. It could be argued that full taxation of capital gains would immobilize capital by causing investors to become locked-in an investment in order to avoid incurring tax upon realization of the accrued appreciation. The issues related to economic effects could also involve the consideration of overall reductions in rates and integration of the individual and corporate income taxes.

If it were decided to repeal preferential treatment for capital gains, a number of issues would arise concerning problems relating to inflation, "bunching" of income and the "lock-in" effect. Some of the approaches to these issues often suggested would introduce either similar or different forms of complexity into the tax law. These issues and the various solutions are set forth in the following discussion.

a. Indexing

One approach to deal with inflation-induced gains would be to provide for basis adjustments tied into an index to reflect the inflation sustained over the holding period of the asset. The acquisition cost, then, would be translated into present values which would be used to reduce a nominal gain to real gain.

This approach would significantly reduce the degree of simplification which would otherwise be achieved by repealing special capital gains treatment. An adjustment mechanism tied into an inflation index would necessarily involve complex computations. The computations would be further complicated if, in addition to acquisition cost, unpaid acquisition debt were adjusted for inflation in computing the real gain realized upon a sale or exchange of debt-financed property. In addition, many of the definitional problems under present law would be continued since the types of property eligible for the adjustment must be prescribed.

Although the indexing approach might partially alleviate the bunching problem, it might aggravate the lock-in problem depending upon how the provision is structured. A taxpayer may continue to hold an asset simply to satisfy an eligibility requirement based on some minimum holding period or in anticipation of future inflation.

Furthermore, if accrued but unrealized appreciation is considered current income in an economic sense, an *argument* could be made that any adjustments to basis for inflation should be balanced with an interest charge for the privilege of deferring payments of tax on appreciation until gain is actually realized.[22] It could be argued that an ancillary benefit of a deferral charge could be a reduction of the tendency of investments to become "locked-in." Investors would not gain by post-

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[22] Even the introduction of an interest charge to offset the advantages of tax deferral leaves a residual of preferential treatment for property held long-term, the gain from which is taxed only upon realization, compared to the treatment of income generated from other sources which is taxed annually as it is received. Until the deferral charge actually is collected with the tax on the gain, the taxpayer still has the use of, and the benefits attainable from, the property. Conversely, wages, for example, are subject to tax, generally, before the taxpayer can use that income.

poning taxes; in fact, they would pay increased taxes, in the form of the deferral charge, the longer they held the property.

Although some have argued that both inflation adjustments and deferral charges would be desirable for the structuring of an efficient and equitable tax system which encompasses the full inclusion of capital gains in taxable income at ordinary rates, their implementation undoubtedly would complicate the tax system. Taxpayers would have to maintain complete records of the acquisition costs of property, including separate records for additions to an asset since such improvements would require the application of deferral charges and inflation adjustments which differ from those applicable to the original property. Similarly, complete records would have to be retained on stock splits, dividends, and recapitalizations, as well as on other corporate adjustments. Although most of these records are generally maintained under present law, keeping more detailed records might be more important for indexing purposes.

Distinctions would have to be made, and recorded adequately, between the acquisition cost of property and its appreciation and, if there is to be "tacking" of holding periods for property exchanges, assets and their appreciation for which the first property was exchanged in a non-taxable transfer. Special rules would be necessary to prescribe the indexing period for separate components of a single property where additions or improvements are made after the original acquisition, e.g., building additions. In addition, some method might have to be formulated to take into account the effect of the tax benefits of certain accelerated deductions on the determination of the appropriate adjustments and charges, i.e., on the ground that the effect of inflation has been partially offset by the benefits of accelerated deductions. Likewise, special consideration would have to be given to the design of the charges and adjustments to reflect properly the treatment of losses within the tax system.[23] Moreover, it would appear that the deferral charges would have to be differentiated, in some manner, from ordinary deductible interest.

Another potentially complicating consideration would be the interrelationship of the deferral charges and the computation of the tax on the adjusted gain under an averaging system. Theoretically, the adjustments for inflation and deferral would be independent of the averaging mechanisms. The adjustments would be intended to determine the taxpayer's real gain, and to compensate for deferral. The averaging device is designed to alleviate the impact of the progressive rates on gain (in this case, as adjusted for inflation) which accrued

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[23] A system of deferral charges implies the necessity for a parallel system of deferral credits. *See, e.g.*, Brinner, *Inflation, Deferral and the Neutral Taxation of Capital Gains*, 26 Nat'l Tax J. 565 (1973) ; Vickrey, *Tax Simplification Through Cumulative Averaging*, 34 L. & Contemp. Prob. 736, 740–741 (1969). The deferral credits could be claimed with regard to property on which the taxpayer incurred a real loss, after adjustment for inflation. Since the deferral credits would be available in the same year in which the loss was realized, the combination of the two items might equal a significantly greater sum than several years of the taxpayer's tax liabilities. This might occur even where the taxpayer experiences a nominal gain on the sale of the property, but where the "gain" is converted into a real loss by the inflation adjustment. *See, e.g.*, Brinner, *supra*, at 568, for an example of how this could occur. Therefore, the combination could result in substantial refunds which would not be available in the absence of deferral credits and inflation adjustments.

over a number of years but which was realized, or "bunched", in one taxable year. Thus the gain would have to be adjusted to the real gain, which then would be subject to the averaging rules to determine the tax due on that gain. The deferral adjustments, like those for inflation, would have to be made independently of the averaging system. The total tax attributable to the property sold or transferred will be the sum of the deferral adjustments plus the tax on the gain determined under the averaging provisions. Since the use of the averaging rules requires reference to other items of income, or other years' returns, the entire process could become complicated, at least as to the instructions which would be necessary to accompany the income tax return forms.

An alternative to the introduction of either an inflation or a deferral adjustment would be to adopt neither, while both including capital gains fully in taxable income at the ordinary income rates, and providing a special averaging mechanism. This is the less complicated alternative, and one which achieves nearly all of the objectives of the more intricate alternative. One economist has argued that over a given period the effect of inflation on an asset's value will be approximated by the tax benefits of deferral.[24] Accordingly, it is argued that gains could be included fully, as realized in taxable income without the necessity of complicating the tax system with adjustments for inflation or deferral.

b. Special averaging

Special averaging for capital gains basically would alleviate the effect of the application in one year of graduated tax rates to gains which have accrued over several years. However, it might introduce definitional and computational complexities which are either different from or similar to those associated with the present treatment of capital gains.

Special averaging limits the inclusion of gain or loss in establishing the marginal tax rate, thereby approximating the tax consequences which would have occurred if the gain or loss had been realized in equal installments over the period during which the taxpayer held the property.[25]

The argument for special averaging is based on an assumption that the present 5-year averaging device (which is discussed below) does not provide sufficient relief for gains from property held over a long

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[24] Brinner, *supra*, at 567, 570. Since this method is less precise than the alternative of making the adjustments, Brinner does not list it as the first choice for a more efficient and equitable method of taxing capital gains in full at ordinary rates. However, it is indicated to be a superior alternative to the present system. One factor that the Brinner studies apparently do not consider is the amount of complexity which the adjustments would introduce into the tax law. The loss of precision in simply allowing the adjustments to cancel each other may be compensated for by the reduction of complexity needed to implement the adjustments.

[25] Generally, proration is designed to average a limited group of highly variable or bunched incomes rather than covering all types of income and losses. *See, e.g.*, M. David, Alternative Approaches to Capital Gains Taxation 166 (1968) ; R. Goode, The Individual Income Tax 199 n. 23 (1964) ; U.S. Treas. Dept., Tax Advisory Staff, *Federal Income Tax Treatment of Capital Gains and Losses* 89 (1951) ; Steger, *Economic Consequences of Substantial Changes in the Method of Taxing Capital Gains, in*, 1959 Tax Revision Compendium (pt. 2) 1261.

period of time. The validity of this assumption may depend upon the normal holding period for a particular category of assets.

Under any alternative for special averaging, most of the definitional complexities of present law would be continued since the property eligible for the provisions would have to be defined.

There are, however, several possible variations of special averaging which could be considered. For example, the gain or loss realized from each sale or taxable disposition of a capital asset could be allocated in equal-size increments over the years the asset was held. The tax for each of those years then could be recomputed, with the difference between the amounts actually paid and the sum of the computed taxes payable or creditable in the year of realization. However, this method would be highly complex, difficult to administer, and would require the maintenance of complete records over lengthy periods. This method was one of the earliest considered by the Congress for providing special tax treatment for capital gains, but was rejected due to complexity, and administrative and compliance problems.

Another possible method of avoiding the bunching problem, and one which is more administratively practical, would be to allocate the gains and losses equally over a fixed, but arbitrary, time period such as 5 or 10 years, regardless of the length of the actual holding period. The taxpayer then would divide the current year's net realized gain or loss by the number of years selected for the averaging period. The tax for each of the preceding years within the averaging period then would be recomputed on the basis of the ordinary income for each of those years plus the prorated amount of gain or loss, at the rates applicable for each of those years. The tax or credit attributable to the gain or loss would be the difference between the total taxes actually paid and the sum of the recomputed tax liabilities.

Although this variation of special averaging would be more administratively feasible than allocating the gain or loss over the entire length of the taxpayer's holding period, the increased feasibility is relative only as to the potentially decreased number of years which would have to be taken into account for purposes of recomputing the new tax liability. Moreover, the need for accurate records would not be diminished, and the complexity involved would be reduced only in relation to the number of years chosen for the averaging period.

Special averaging methods generally are suggested with the allocation of gain or loss backward over the time during which the gain or loss is considered to have accrued for income tax purposes. Administratively, however, forward averaging might be more practical because it would not require opening prior year returns. ("Forward" averaging does not take prior periods into account. Generally, a portion of a gain is stacked on other current year income to determine the marginal rate for the entire gain.) Nevertheless, forward averaging may increase the benefits of deferring the tax, and increase the ability to manipulate tax rates either by reducing ordinary income or by realizing losses.

To avoid the complexities associated with the opening of past-year returns and the bunching problem, a method similar to the averaging for lump sum distributions from qualified retirement plans could be adopted. Essentially, this method would allocate the gain or loss over an arbitrarily selected number of years, and would determine the tax rate applicable to the entire gain or loss by considering the pro rata amount as a marginal addition to, or deduction from, the current-year income. The tax attributable to that portion would then be multiplied by the number of years selected for averaging. This amount would then be added to the tax determined for other income. However, it should be noted that this method would discriminate in favor of taxpayers who turn over assets more frequently and against those who hold assets for a relatively long period. Relief from the recognition of "bunched" income would generally diminish the longer an asset is held, e.g., if a 5-year averaging period were provided, appreciation accruing over a 20-year period would be treated as accruing over a 5-year period.

c. Percentage exclusion

Another method of dealing with the problem of bunched gains is the partial inclusion of gain. The provision of a percentage exclusion would maintain definitional and computational complexities similar to those associated with the 50-percent long-term capital gain deduction under present law.

Special averaging has a decided advantage over a percentage inclusion, or sliding scale method of attempting to alleviate the impact of progressive tax rates on the current realization of gain which accrued over a number of years. The elaborate percentage exclusion system employed from 1934 to 1937 demonstrated that the tax benefit from such a mechanism would vary directly with the taxpayer's marginal tax rate.[26] For example, the 50-percent exclusion of present law benefits those taxpayers the most whose gains would be taxed entirely at the highest marginal tax rates. The tax benefits of special averaging, on the other hand, depend on the breadth of the tax bracket and on the difference in rates between tax brackets.

Special averaging would tend to eliminate the reluctance to dispose of assets, while percentage exclusion, especially a sliding scale method, may aggravate the lock-in problem.[27]

The percentage exclusion method of attempting to equate current year's tax with that which would have been due had the gain been included in the tax base in the years in which it presumably was earned, may exacerbate the lock-in effect.[28] Although reliable data

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[26] *See* U.S. Treas. Dept., Tax Advisory Staff, Federal Income Tax Treatment of Capital Gains and Losses 26–29, 68–69 (1951).

[27] Rollover provisions have been suggested periodically as a method of facilitating capital formation, and relieving the lock-in effect. Basically, rollover is a principle which postulates that the lock-in effect of capital gains taxation will be alleviated by the postponement of tax liability so long as the proceeds received from the disposition of an asset are reinvested in an appropriate qualified manner. "Rolling-over" of capital gains is essentially a method of deferring all tax on the gain, except to the extent that any proceeds are not reinvested in a qualified fashion. While rollover provisions probably do decrease the basic lock-in effect, they probably also increase the tendency of investments to become locked-in in qualified investments. Moreover, rollover provisions do little or nothing to simplify the tax system or to promote equity among taxpayers.

[28] Cf. U.S. Treas. Dept., Tax Advisory Staff, Federal Income Tax Treatment of Capital Gains and Losses 26–27 (1951) ; *see generally*, Brown, *The Locked-in Problem*, *in* Federal Tax Policy For Economic Growth And Stability 376, Joint Comm. On The Economic Report, 84th Cong., 1st Sess. (1955) ; M. David, Alternatives Approaches to Capital Gains Taxation 198–208 (1968).

on this point is scarce, percentage exclusion methods, especially those which contain a sliding scale formula in accordance with the percentage of the gain excludible increases with the length of the holding period, would require taxpayers to continuously ascertain what tax consequences would result from a potential sale (rather than merely ascertaining if a 9-month or 12-month holding period had been satisfied).[29]

However, if the exclusion is gradual enough, a sliding scale should not precipitate a noticeable increase in investment lock-in. Nevertheless, it does maintain the differentiation of income according to its source.

d. Loss limitations

If the special capital gains treatment were to be repealed, another issue would be whether losses from dispositions of capital assets would be allowed without limitation or would be subject to some limitation for the amount which could be used to offset other income either by a fixed dollar amount or by a percentage limitation tied to income. Without a limitation, taxpayers could engage in loss-taking to reduce or eliminate tax on other income. On the other hand, the imposition of a loss limitation for "capital assets" would continue many of the definitional problems under present law.

It has been suggested that some of the definitional problems could be alleviated by restricting the loss limitation to "securities" or to "marketable securities." However, it might be necessary to provide a detailed definition of securities. For example, the term "securities" could include the following: stocks, convertible securities, debentures, bonds, notes, or other evidences of indebtedness, puts, calls, options, warrants, futures, commodity futures, open-ended or closed mutual funds, and any evidence of an interest in or right to subscribe to or purchase any of the foregoing.

In addition, the term could include an interest in a partnership, syndicate, or other enterprise if, at any time, any interest in those organizations has been offered for sale in an offering required to be registered with a Federal or State agency having the authority to regulate the offering of securities, or other property (including real estate sales), for sale. Furthermore, it could include an interest in a partnership, syndicate, or other enterprise with respect to which there is no registration requirement if, at any time, public or private offerings have been made through a securities dealer, dealer-broker, or real estate company.

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[29] *Id., Compare* 1973 Panel Discussions (pt. 2), at 253 (Testimony of B. Kenneth Sanden).

Section 2506 of H.R. 10612, as reported by the Senate Finance Committee as an additional committee amendment in 1976 would have adopted a sliding-scale formula under which one percent of an individual's capital gain on an asset would be excluded for each year, in excess of five years, that the asset was held. This exclusion provision was to be in addition to the present 50-percent deduction under § 1202, but was to be limited to an additional 20-percent exclusion, i.e., for holding periods over 25 years. The proposed amendment would have repealed the 25-percent alternative tax rate, treated substantial additions to basis as a separate asset, and used special rules to cover situations where the taxpayer's holding period tacked. The reasons given for the amendment were to relieve the lock-in effect and to promote capital formation. The committee amendment was not adopted by the Senate.

G. Minimum and Maximum Tax Provisions

1. In general

Present law provides a minimum tax of 15 percent on certain tax preferences and a maximum tax rate of 50 percent on personal service income. The amount of tax preferences reduces the amount of personal service income qualifying for the maximum tax and thus increases the highest marginal rate on personal service income from 50 percent to as high as 70 percent. These provisions were enacted in 1969 to discourage excessive use of tax preference items. The impact of the maximum tax was conceived to be indirect, i.e., the desire to seek out shelters would be reduced if a lower rate applied to earned income. On the other hand, the minimum tax is imposed on tax preferences to insure that income tax cannot be completely avoided through the use of preferences.

The minimum tax generally is 15 percent of the amount by which the sum of a taxpayer's tax preference items [30] exceed the greater of $10,000, or one-half the regular income tax. Special rules are provided to defer or reduce the minimum tax where the taxpayer has a net operating loss for the year or is otherwise unable to benefit currently from the preference. Tax preferences from foreign sources are subject to minimum tax only to the extent they reduce regular income taxes on domestic source income.

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[30] The following preference items are included in the base of the minimum tax:

(1) Adjusted itemized deductions in excess of 60 percent of adjusted gross income;

(2) Accelerated depreciation on real property in excess of straight-line depreciation:

(3) Acceleration on depreciation on leased personal property in excess of straight-line depreciation;

(4) Amortization of certified pollution control facilities (the excess of 60-month amortization (sec. 169) over depreciation otherwise allowable (sec. 167));

(5) Amortization of railroad rolling stock (the excess of 60-month amortization (sec. 184) over depreciation otherwise allowable (sec. 167));

(6) Qualified stock options (the excess of the fair market value at time of exercise over the option price);

(7) Reserves for losses on bad debts of financial institutions (the excess of the special deduction for such institutions over the bad debt reserve deduction allowable on the basis of actual experience);

(8) Percentage depletion in excess of the adjusted basis of the property;

(9) Capital gains (for individuals, one-half of net long-term capital gains; for corporations in general, 18/48 of net long-term gains);

(10) Amortization of on-the-job training and child care facilities (the excess of 60-month amortization (sec. 188) over depreciation otherwise allowable (sec. 167)):

(11) Intangible drilling and development costs (sec. 263) in excess of the amount which would have been deductible if the costs had been capitalized and straight-line recovery of intangibles used but only to the extent that such excess exceeds the taxpayer's net income from oil and gas properties for the taxable year.

The maximum tax on personal service income provides that taxable personal service income will not bear a rate of tax higher than 50 percent unless the taxpayer elects to use income averaging. For this purpose, taxable personal service income consists generally of earned income (including pensions and annuities) reduced both by deductions allocable or apportionable to the earned income and by the sum of tax preferences for the year. All other income is taxed under the normal progressive rate structure at rates not less than 50 percent.

2. Issues concerning simplification by repeal or substantial revision

The basic issues concerning repeal of the maximum tax or the minimum tax relate to social and economic incentives since the provisions are intended to discourage excessive use of tax incentives.

In considering simplification of the minimum and maximum taxes, it should be noted that these provisions generally affect only medium and higher income taxpayers who usually receive professional tax assistance. The added complexity imposed on taxpayers by these taxes may be minor in relation to that already borne.

3. Specific areas of complexity

A number of calculations are required under these provisions. In addition, there is an interrelationship between the provisions involving tax preferences. Simplification of the existing minimum tax and maximum tax provisions is possible, but would, in nearly all cases, involve diluting or repealing some element of the scheme of limitations on preferences. For example, in the maximum tax provisions, the reduction of personal service income by tax preferences might be repealed. Although this would simplify the law by eliminating the interrelationship of maximum and minimum tax, it would involve, however, some lessening of the limitation on use of preferences.

Eliminating some of the tax preference items could simplify the operation of the minimum tax. Since the long-term capital gain preference currently accounts for approximately 89 percent of the revenues raised by the minimum tax, the other preference could be eliminated from the minimum tax base without involving a serious reduction of minimum tax revenues. However, it is difficult to measure the effect of the minimum tax upon tax planning involving the use of preferences to reduce other income. An evaluation of each individual preference could be made to determine if some should be eliminated. Similar studies could determine if other items should be treated as preferences.

H. Income Averaging

1. In general

Under present law, there are two separate income averaging provisions. One is referred to as general or standard income averaging. The other provides special averaging for certain lump sum distributions from tax qualified retirement plans.

Under the general averaging provisions, the income tax is computed by averaging income over a 5-year period (the current taxable year and a base period consisting of four preceding taxable years). Generally, a taxpayer must have "averagable" income in excess of $3,000 to be eligible for the general averaging provision. For this purpose, averagable income is the excess of taxable income, after certain adjustments, over 120 percent of the average base period income.

The general averaging provision is designed to mitigate the impact of the progressive rate structure upon individuals whose income fluctuates widely from year to year or increases rapidly over a short period. It reduces the disparity that otherwise would exist between taxpayers whose income is received erratically and taxpayers whose income is approximately the same in the aggregate but which is spread more evenly from year to year. Thus, the underlying purpose of the general averaging provisions is to provide horizontal equity among taxpayers who have approximately equal incomes over a period of years.

Under the special averaging provision for lump sum distributions the amount of such a distribution which constitutes ordinary income is eligible for special 10-year forward averaging. A separate tax is computed to yield roughly the equivalent of what the tax would be if the individual were to receive his interest in the plan over 10 years. To qualify for this treatment, the employee must have been a plan participant for at least 5 full taxable years.

The portion of the distribution attributable to participation in a plan prior to 1974 is eligible for capital gains treatment. (In effect, this provision grandfathers the capital gains treatment available prior to changes to the lumpsum distribution rules in 1969 and 1974.) However, if the special 10-year averaging is more beneficial, a taxpayer may elect to treat this portion as being subject to 10-year averaging instead of capital gains. Amounts subject to the special tax on lump sum distributions are treated as a deduction from gross income in computing the regular income tax on other income and, therefore, are not taken into account for purposes of the general income averaging provision. Thus, taxpayers with lump sum distributions consisting of both ordinary income and capital gain must make several computations to determine their lowest tax. For example, they may elect general income averaging on all their income, including the ordinary income and capital gain of the lump sum distribution; or 10-year averaging on the ordinary income portion,[31] and general averaging on the total of the capital gain portion and their other income; or alternative capital gains tax on the capital gain portion, 10-year averaging on the ordinary income portion, and regular tax on their other income. Some taxpayers may also have to consider the effect of the minimum and maximum taxes in making those computations.

As in the case of the general income averaging provision, the basic purpose of the special averaging provision is to deal with the bunching of income in one taxable year.

2. *Issues concerning simplification by repeal or substantial revision*

Repeal of the general income averaging provision would unquestionably simplify the tax laws. However, repeal would impose inequities on a significant number of taxpayers. For example, Internal Revenue Service Statistics show that for 1973 general averaging was used by approximately 2,174,100 individual taxpayers. The average tax saving shown on these returns was $652 (ranging from an average of $259 for returns with adjusted gross income of $1 million or more).[32]

The same arguments can be made for and against repeal of the special averaging rules for lump sum distributions from qualified retirement plans. Special averaging was used on 24,273 returns for 1973 (prior to the most recent change in the special averaging rules). The average tax saving was $937 per return (ranging from an average of $462 for returns with adjusted gross income under $20,000 to an average of $68,021 for returns with adjusted gross income of $1 million or more).[33]

Statistics are not available for the rate of errors made on the general or special averaging forms or the number of taxpayers who overlook the benefits of averaging. The Internal Revenue Service does not presently include Forms 1040G and 4972 (the general and special averaging forms) in the forms and instruction booklet mailed to taxpayers each year. Inclusion of these forms in the standard package, as urged by various commentators, might increase use of income averaging.

Rather than repealing the averaging provisions, the Congress may wish to explore methods of simplifying the existing provisions through structural changes. One possible way of simplifying the law would be to combine the two separate averaging provisions into a single provision. This approach could eliminate the need to make alternative computations to determine which method is more advantageous, and some of the definitional and qualification problems concerning the special averaging provision might be eliminated. However, it may be argued that general averaging based on a five-year period is inadequate to deal with the unusual magnitude of bunched income in many cases of lump sum distributions from qualified plans, and that a longer averaging period is necessary to provide equitable treatment.

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[31] The Employee Retirement Income Security Act of 1974 amended the special averaging provisions to eliminate other complexities which had arisen under the law as amended by the Tax Reform Act of 1969.

[32] Source: Individual Income Tax Returns—Statistics of Income 1973.

[33] Id.

3. Other issues

There are a number of other issues to be considered if the Congress were to review the averaging provisions for the purpose of making structural improvements to simplify the existing law.

One issue concerns the question of who qualifies for general averaging. Under present law, income averaging is not intended to benefit persons who are just embarking on their income earning years. It is expected that the incomes of such individuals will rise rapidly in relation to years when they were supported by parents, and there is no need to provide special benefits for them. In order to prevent their use of income averaging, a special rule is provided to exclude those who did not provide at least one-half their support during the four preceding base period years. The question of support does give rise to controversy.

Another issue concerns the number of special adjustments to taxable income required under the general income averaging election. For example, taxable income must be adjusted for so-called "excess community income" (the earned income reported on a separate return by a spouse under community property laws which was actually earned by the other spouse), premature distributions from self-employed qualified retirement plans, and income which has been excluded because it was foreign source income (secs. 911 and 931). Further, special rules apply to accumulation distributions from trusts. In 1969, a number of additional adjustments were eliminated to simplify the averaging provisions.[34] Although significant simplification could be achieved by eliminating these remaining adjustments, the absence of these rules would make significant tax avoidance opportunities available.

Substantial complexity is also created in the situation where the taxpayer's marital status has changed during the 5-year averaging period. For example, if a husband and wife were married to different persons during any of the base period years they must reconstruct base period income by adding together their separate base period incomes. To compute separate base period income, they must each allocate base year items of adjusted gross income between their former spouse and themselves and allocate other deductions in the ratio of the separately determined adjusted gross income. The problem with eliminating these rules entirely is that some method of making the current and four base years reasonably comparable is necessary to avoid manipulation, and, in some cases, inequity. However, the computation need not be quite so exact, and rough equality might be possible by using an arbitrary 50-percent allocation between husband and wife.

A final issue concerns the choice between alternative benefits. This issue will affect only a small number of taxpayers. If the benefits of general income averaging are chosen, a taxpayer cannot use tax benefits for that year for (1) the alternative tax on capital gains, (2) exclusion of foreign source earned income, or (3) the maximum tax on

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[34] Under the Tax Reform Act of 1969, the benefits of averaging were extended to long-term capital gains, wagering income, and income derived from property received by gift or inheritance, in order to simplify the income averaging computations. The previous exclusion of these items required complex computations to determine averagable and base period income. Original concerns about allowing th ebenefits of averaging for these items were outweighed by the complexities the exceptions entailed.

earned income. Thus, where the taxpayer has any income eligible for these benefits, several alternative calculations of tax may be necessary to determine which is more advantageous. The mere existence of these alternatives makes the law complicated because one can never be sure that all the subtle interrelationships are comprehended. If a lump sum distribution from a qualified retirement plan is also received, an additional computation may be required to determine if the general averaging benefits outweigh the benefits from the special 10-year forward averaging benefits. Although not many taxpayers will be affected by this, it may impose significant burdens on the administrator of a qualified retirement plan since, as long as the alternatives are available, the plan administrator must furnish the necessary information. One solution to this problem would be to impose a single "rough justice" tax on lump sum distributions and eliminate the alternatives.

VI. SUMMARY OF RECENT LEGISLATION AND PROPOSALS CONCERNING TAX SIMPLIFICATION

This section of the report summarizes recent legislation as well as prior Administration and other proposals concerning tax simplification.

A. Tax Legislation

The Tax Reduction and Simplification Act of 1977 contained the most important simplification changes made in recent legislation. In addition, most other recent tax legislation has contained some amendments designed to simplify particular provisions of the tax law. For example, the income averaging rules were simplified under the Tax Reform Act of 1969, certain aspects of the depreciation rules were simplified under the Revenue Act of 1971, and the rules relating to the treatment of lump sum distributions from qualified retirement plans were simplified under the Employee Retirement Income Security Act of 1974. In terms of the overall breadth and purposes of these Acts, the amendments designed to simplify particular provisions might be considered relatively minor items. For this reason, the summary of recent tax legislation only covers the principal simplification changes contained in legislation enacted in the last several years.

1. Tax Reduction and Simplification Act of 1977

The Tax Reduction and Simplification Act of 1977 made changes which will significantly simplify the preparation of Federal income tax returns and the computation of tax liability for almost all individual taxpayers for 1977 and subsequent years. As a result of this Act, 96 percent of all individual taxpayers may be able to determine their regular income tax from revised tax tables rather than computing the tax on the basis of rate schedules. The revised tables will also eliminate computations for personal exemptions, the general tax credit, and what was formerly the standard deduction.

The Act eliminated the minimum percentage and maximum standard deductions and replaced them with a flat standard deduction of $2,200 for single persons and heads of households, $3,200 for married individuals filing joint returns, and $1,600 for married individuals filing separate returns. The standard deduction was restructured as a zero rate bracket to include these flat amounts in the tax tables and rate schedules so they will not have to be computed.

These changes will enable the Internal Revenue Service to issue individual income tax forms for 1977 which are much simpler and easier to complete for both itemizers and nonitemizers.

The creation of a flat "standard deduction" will simplify the tax forms by totally eliminating the prior presentation of the standard deduction on the form. Under prior law, five numbers relating to the standard deduction had to be shown just for married and single taxpayers (two minimums, a percentage of income, and two maximums) on both the form 1040 and the 1040A short form. In addition, this change eliminated the tax tables based on taxable income which were adopted in the Tax Reform Act of 1976 and returned to a system of tax tables based on adjusted gross income (AGI) and the number of exemptions. To compute tax liability with the use of tax tables based on taxable income, the following steps were required—

(1) subtracting from the taxpayer's AGI the standard deduction and personal exemptions ($750 times the number of exemptions) to determine taxable income,

(2) using taxable income and filing status (married, single, etc.) to determine tax liability from the tax table,

(3) computing the general tax credit (the greater of $35 per capita or 2 percent of taxable income up to $9,000), and

(4) subtracting the general tax credit from the tax amount obtained from the tables.

Under the changes adopted in this Act, taxpayers claiming the standard deduction simply look up the tax in the tables based on adjusted gross income and number of exemptions.

The new tax tables will be available for nonitemizers, for example, with adjusted gross income of not more than $20,000 for single returns and $40,000 for joint returns, and three or fewer exemptions for single returns and nine or fewer exemptions for joint returns. (The Internal Revenue Service is authorized to expand the tables to cover additional taxpayers by selecting higher amounts.) However, the new tax tables will not be available for taxpayers who compute taxes under special provisions such as income averaging or the maximum tax.

Under the changes made by the Act, itemizers with income and exemptions under the maximum amounts that permit a taxpayer to use the tax tables will use the same tax table used by nonitemizers. This is accomplished by imposing as a floor on itemized deductions the amount of the flat standard deduction, which the Act built into the tax tables as the zero bracket. As a result of the change, itemizers perform the following calculations:

(1) Subtract the standard deduction (zero bracket amount) from their itemized deductions to determine their itemized deductions in excess of the floor;

(2) Subtract these excess itemized deductions from their adjusted gross income to obtain their "tax table income"; and

(3) Using this income, look up their tax in the tax table based on this "tax table income" and number of exemptions. This is the same table used by taxpayers claiming the standard deduction.

In this way, itemizers receive the full benefit of their itemized deductions (because the amount of the standard deduction used as the floor under itemized deductions is built into the tax tables) but do not have to compute and subtract their personal exemptions or calculate and subtract the general tax credit. All of these computations are built into the tax tables, just as they are for taxpayers claiming the standard deduction.

A comparison of the computations required of taxpayers using the new tax tables provided by the 1977 Act with the computations required on the 1976 income tax forms is outlined in the table below.

Table 10.—Examples of Tax Computations Under Prior Law and Present Law

CASE 1.—STANDARD DEDUCTION; FAMILY OF 4, WITH $15,000 AGI

Prior law

1. Adjusted gross income	$15, 000
2. Determine standard deduction (16 percent of income but not less than $2,100 nor more than $2,800) and subtract from income	2, 400
3. Difference, line 1 less line 2	12, 600
4. Multiply number of exemptions by $750	3, 000
5. Subtract line 4 from line 3	9, 600
6. Look up tax in tax table	1, 727
7. Compute general tax credit (greater of $35 times number of exemptions; or 2 percent of line 5 but not more than $180)	180
8. Subtract line 7 from line 6 to get tax after credit	1, 547

Present law

1. Adjusted gross income	$15, 000
2. Look up tax in new tax table	1, 385
(The lower tax under present law reflects the increase in the standard deduction.)	

CASE 2.—ITEMIZED DEDUCTIONS FOR THOSE USING TAX TABLES; FAMILY OF 4, WITH $15,000 AGI AND $4,000 ITEMIZED DEDUCTIONS

Prior law

1. Adjusted gross income	$15, 000
2. Total itemized deductions	4, 000
3. Difference, line 1 less line 2	11, 000
4. Multiply number of exemptions by $750	3, 000
5. Subtract line 4 from line 3	8, 000
6. Look up tax in tax table	1, 375
7. Compute general tax credit (greater of $35 times number of exemptions; or 2 percent of line 5 but not more than $180)	160
8. Subtract line 7 from line 6 to get tax after credit	1, 215

Present law

1. Adjusted gross income	$15, 000
2. Itemized deductions	4, 000
3. Floor on itemized deductions	3, 200
4. Excess itemized deductions, line 2 less line 3	800
5. Tax table income, line 1 less line 4	14, 200
6. Look up tax in new tax table	[1] 1, 225

[1] Tax is $10 higher than prior law because the income is at the bottom of a bracket in the new tables and the tax is computed at the bracket midpoint.

2. *The Tax Reform Act of 1976*

Several provisions of the Tax Reform Act of 1976 simplified some of the more complex deductions and credits for individuals.

One of these provisions was designed to simplify the retirement income credit. The credit was originally designed to give those who retire without social security a tax benefit similar to that accorded social security benefits. As a result, eligibility for the credit and its computation were designed to follow as closely as possible eligibility for, and computation of, social security benefits. This required a complex form that filled a whole page and it was estimated that many people eligible for the credit either did not claim it or made errors in computing it. In response to this problem, the Congress restructured the credit in the 1976 Act to eliminate virtually all the complexity, by breaking the close link between the retirement income credit and social security eligibility.

Another complicated provision has been the sick pay exclusion. In this case, Congress concluded that the exclusion should be allowed only for persons who are permanently and totally disabled, since for other people there is no reason to treat sick pay more favorably than wage income, particularly in view of the deductibility of medical and drug expenses. The Congress therefore eliminated the exclusion of sick pay for temporary absences from work. For those still eligible for the disability income exclusion, the provision was considerably simplified and coordinated with the new credit for the elderly.

The 1976 Act also made major changes in the treatment of child and dependent care expenses. Formerly, these were allowed as an itemized deduction, subject to some complicated limitations. The Act converted the deduction into a 20-percent credit, so that it will be available to those who use the standard deduction as well as to itemizers, and so that it will provide the same tax relief to taxpayers in low brackets as to those in high brackets. In addition, the Act simplified the child care provision and broadened eligibility for it.

The Act made several other changes that will simplify the law, including a revision of the rules relating to accumulation trusts and the moving expenses deduction. The alimony deduction was changed from an itemized deduction to a deduction in determining adjusted gross income, so that it can be used by people who take the standard deduction.

The Act included "deadwood provisions" which deleted obsolete and rarely used provisions from the Internal Revenue Code and made many other changes to shorten and simplify the language of the Code. Under these provisions, approximately 2,370 amendments were made, including the amendment of 850 sections and the repeal of almost 150 other sections.

On the other hand, the Act contained tax reform provisions that added some complexity, e.g., the provisions designed to deal with tax shelters. In addition, the retroactive aspect of a few of the Act's provisions contributed to complexity for taxpayers and the Internal Revenue Service. These complexities were heightened by subsequent changes to the effective dates by the Tax Reduction and Simplification Act of 1977.

B. Other Legislation

In addition to recent tax legislation, several other recent Acts have some connection with tax simplification. These Acts are described below.

1. Public Law 94-202

Currently, employers file five reports for a calendar year with the Federal Government for each employee's earnings. Four of these reports are filed with quarterly payroll tax returns for social security purposes. An employee's quarterly social security wages are reported on these reports. The fifth report is filed with the Internal Revenue Service on an annual basis for income tax purposes.

For a number of years, proposals have been discussed to combine these reporting requirements to reduce recordkeeping and paperwork. Under Public Law 94–202, which is effective for wages paid after December 31, 1977, a major step was taken in the direction of accomplishing this objective. Other legislation is under consideration which also would further this objective by permitting records and reports for social security purposes to be maintained on an annual basis.

Combined annual wage reporting, while it will be of assistance to the Federal Government, is expected to benefit chiefly the small and medium sized employer. Past estimates indicated potential savings of $235 million per annum for these employers if the quarterly basis for social security were eliminated. Significant savings are not expected to accrue to larger employers because their payroll systems are automated.

The specific changes and instructions to implement the changes made by Public Law 94–202 are being developed. At this time, it is anticipated that employers will no longer have to file quarterly reports on the earnings of each employee. In addition, it is anticipated that one annual report for income tax purposes (Form W–2) will be redesigned to meet the data needs of both the Internal Revenue Service and the Social Security Administration. The quarterly payroll tax return (Form 941) will, of course, still be required.

2. *Congressional Budget Act of 1974*

In an indirect way, the Congressional Budget Act of 1974 may have a future impact upon simplification of the tax laws. As previously noted, the existence of revenue loss constraints attributable to resolutions adopted pursuant to the Congressional Budget Act may affect the choice of alternative approaches in considering tax legislation and thereby have a bearing on the complexity of the provisions. The Act may have a bearing upon tax simplification in other ways.

The Act created the Congressional Budget Office (CBO). Among its responsibilities, the CBO staff is charged with the responsibility for making a comprehensive assessment of tax expenditures as part of its budgetary analysis. As this function is performed, the CBO information could be utilized by the tax-writing committees and their staffs in evaluating the effectiveness of tax expenditure items. Since the tax expenditure items often contribute to complexity of the tax laws, the analyses of their effectiveness could be useful in a review of the items for simplification purposes.

C. Congressional Rules Changes

On February 4, 1977, the Senate approved a rules change that may have an effect on tax simplification in that information concerning the anticipated costs of compliance will be developed for certain bills. As changed, Rule XXIX of the Standing Rules of the Senate requires all committee reports to contain a determination of the amount of additional paperwork that will result from regulations promulgated pursuant to the legislation. This information may include estimates of the amount of time and financial costs required of affected parties. In addition, estimates of the recordkeeping requirements attributable to the legislation may be included.

The development of this kind of information could be useful in evaluating the impact of proposed tax legislation in terms of its impact upon the complexity of the tax laws.

D. Other Recent Proposals by Government Agencies

1. Treasury Department—"Blueprints for Basic Tax Reform"

In January 1977, the Department of the Treasury under the outgoing administration issued a 230-page report, entitled "Blueprints for Basic Tax Reform," which formulates two alternative "model tax systems" designed "to form the basis for practical reform plans." Either model, the Report states, would achieve greater efficiency, fairness, and simplicity than the present individual and corporate income tax structure. The two models are designated as the "Comprehensive Income Tax" proposal and the "Cash Flow Tax" proposal.

a. Comprehensive income tax

This model would modify existing law primarily by taxing corporate income under the individual income tax and eliminating double taxation of dividends; taxing realized capital gains (after certain basis adjustments) in full as ordinary income; broadening the individual income tax base to include State and local bond interest and other receipts or employee benefits not now taxed; and eliminating the standard deduction and certain itemized deductions (including nonbusiness property taxes, medical expenses, and charitable contributions).

Corporate integration

Under "full integration" as proposed by the "Comprehensive Income Tax" model, the corporate income tax would, in effect, be eliminated. Individual stockholders would include in their taxable income their *pro rata* share of the corporation's pretax earnings, whether or not the corporation had distributed its earnings during the year. If the corporation had a loss, the stockholders would deduct their *pro rata* share of the loss. The corporation would annually furnish its stockholders with statements of their shares of corporate earnings or losses.

The shareholder's tax basis in the stock would be increased by the allocable share of income or decreased by the share of loss. The distribution of a cash or property dividend generally would not constitute taxable income to the shareholder, but would reduce the tax basis of the stock. Thus, any gain from selling the stock in a future year would be calculated by subtracting from sale proceeds the original cost basis plus the amount of undistributed corporate earnings which the shareholder had included in income.

To alleviate (at least in part) the "liquidity problem" arising from currently taxing stockholders whether or not they receive dividends with which to pay the tax, the Report suggests imposition of a new withholding tax at the corporate level, with *pro rata* credits to shareholders. While the Report notes that "this withholding system would complicate somewhat the taxation of part-year shareholders," the

Report states that corporate-level withholding would insure, in some but not all cases, sufficient liquidity to pay the tax.

The Report states that full integration, by having the effect of taxing capital gains from stock ownership as they accrue, would eliminate a "major source of controversy and complexity in the present law," notwithstanding the administrative problems identified by the Report[1] and the recordkeeping which would be required for basis adjustment purposes. Also, the Report states that corporate integration would eliminate the necessity for complex rules designed to minimize certain "tax avoidance" mechanisms used by owners of closely held corporations under present law.

Capital gains

Under the "Comprehensive Income Tax" proposal, the special tax treatment of capital gains under current law would be abolished. Capital gains realized would be subject to full taxation, at the same rates applicable to ordinary income, after an adjustment to basis for general price inflation (and, in the case of corporate stock, after the integration basis adjustments). Realized capital losses would be fully deductible against income.

The inflation adjustment would be made by multiplying the asset's cost basis by the ratio of (a) the consumer price index in the year of purchase to (b) the same index in the year of sale. The ratios would be provided by a table accompanying the capital gains tax return schedule. The Report concludes that this proposed annual basis adjustment would be "worth the additional administration and compliance cost."

Other income items

An individual, under this proposal, would include in income the following items currently excluded from the tax base: (a) interest on State and municipal bonds; (b) social security benefits, except Medicare, and veterans' disability and survivor benefits; (c) disability, unemployment, and workmen's compensation; (d) pension and annuity receipts (including return of employee contributions); (e) allocated earnings from pension funds and life insurance reserves; (f) certain health and life insurance premiums paid by the employer; and (g) scholarships and fellowships. At the same time, the proposal would exclude from the tax base employee contributions to pension plans and disability insurance and the employee's share of payroll taxes for social security retirement and disability. The proposal also would include in the tax base only 75 percent of the wage income (up to $10,000) of a "secondary" family wage earner.

The Report states that the proposed broadening of the tax base would permit "a simpler code in that elaborate rules are no longer required for defining items of tax preference or for protecting against the abuse of such preferences." In particular, the Report attributes

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[1] The Report, noting that full integration "is sometimes regarded as posing too many challenging administrative problems," states that "double taxation" of corporate dividends could be eliminated "without introducing significant complexity into the tax code" through a partial integration plan that allowed corporations to deduct dividend payments or allowed shareholders to "gross up" dividends by an amount reflecting the corporate income tax and take a credit for the same amount in computing their tax liability.

much of the complexity of current tax law to the special treatment now provided for capital gain income.

Deduction modifications

The "Comprehensive Income Tax" model would eliminate the standard deduction, the moving expense deduction, and certain itemized deductions (while increasing the exemption allowed per family member and adding a per-return exemption of $1,600). The deductions to be eliminated for itemizers would include (a) property, sales, and gasoline taxes imposed by States or localities, unless incurred in a trade or business; (b) medical expenses; (c) casualty losses; and (d) charitable contributions. (In the case of medical expense and charitable contributions deductions, the Report states that such deductions might be retained or replaced with credits.)

In light of the deduction modifications and proposed simplified rate schedule (three brackets, ranging from 8 percent to 38 percent), the Report concludes that while various presently excluded items would be added to the tax base, "recordkeeping requirements and tax calculation would be simplified greatly" under the "Comprehensive Income Tax" model.

Other proposals

There are other modifications proposed with respect to depreciation, mineral deposit depletion, and foreign income.

b. Cash flow tax

As an alternative to the "Comprehensive Income Tax," the Blueprints Report suggests a "Cash Flow Tax" or "Consumption Base Tax" model, under which an individual's tax base generally would be computed as equal to all monetary receipts (including the entire proceeds from sales of investment assets and any gifts or inheritances received during the year), reduced by net savings and by gifts or bequests made by the taxpayer during the year. The report states that this model "would greatly simplify tax accounting and tax administration regarding real and financial assets," primarily by eliminating the need for accounts to determine capital gains, depreciation, and inventories. Also, the Report declares that this model would avoid "the most difficult problems of measurement" arising under the "Comprehensive Income Tax" model—such as allocation to shareholders of retained corporate income, inflation adjustments to asset basis, and depreciation rules—by virtue of the exclusion from the tax base of all forms of saving.

The Report describes two alternative treatments of investments (such as stock purchases or savings account deposits) under the "Cash Flow Tax" proposal. If a taxpayer acquires an investment through "qualified accounts" established at banks, corporations, stockbrokerage houses, etc., the amounts deposited for purchase would be deductible from receipts in computing the tax base. Any interest, dividends, or gains on such investments would not be taxed as earned, but all account withdrawals (whether attributable to interest, dividends, or sales) would be included in the tax base. The bank or other qualified-account institution would annually report to both the taxpayer and tax authorities the net withdrawals (to be added to the tax base) or net deposits (to be subtracted from the tax base).

The taxpayer could elect, however, to make investments outside of "qualified accounts." If so, no deduction would be allowed for asset purchases, but all returns (such as interest, dividends, and sale proceeds) would be exempt from tax.[2] All consumer durables (such as homes and automobiles) are treated as "outside" assets.

Corporate tax rules

As under the "Comprehensive Income Tax" proposal, corporations as entities would not be subject to income taxation under the "Cash Flow Tax" model. The tax consequences to individuals of dividends, stock purchases, and stock sales would be determined under the alternative "savings deduction" or "earnings exemption" approaches, as summarized above.

Capital gains

Under the "Cash Flow Tax" model, there would be no need to maintain basis records for purposes of computing capital gains. On disposition of a "qualified-account" asset, the full proceeds (if not reinvested) would increase the tax base. In the case of "outside" assets, capital gains would be exempt from tax and capital losses would not be deductible.

Income items

Under this proposal, an individual would include in the tax base (in addition to gifts and inheritances received) the following items currently excluded from income taxation: (a) interest on State and municipal bonds (on withdrawal from "qualified accounts") ; (b) social security retirement benefits; (c) disability, unemployment, and workmen's compensation; (d) pension and annuity receipts (including return of employee contributions) ; (e) receipts from life insurance policies; and (f) fellowships and the like. At the same time, the proposal would exclude from the tax base employee contributions to pension plans and disability, health, and life insurance, and the employee's share of payroll taxes for social security retirement and disability. The proposal also would include in the tax base only 75 percent of the wage income (up to $10,000) of a "secondary" family wage earner.

Deduction modifications, etc.

The "Cash Flow Tax" proposal, among other changes, would eliminate itemized deductions for (a) property, sales, and gasoline taxes imposed by States or localities, unless incurred in a trade or business; (b) medical expenses; (c) casualty losses; (d) charitable contributions; and (e) interest on loans taken outside of "qualified accounts." (In the case of medical expense and charitable contributions deductions, the Report states that such deductions might be retained or replaced with credits.)

The proposal would also modify existing personal exemptions and add a $1,500 per-return exemption. There would be three brackets, with rates from 10 to 40 percent.

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[2] Loans through "qualified accounts" would be included in the tax base; interest and principal payments would be deductible. "Outside" loan receipts would not be added to the tax base; interest and principal payments would not be deductible.

c. *Transitional rule complications*

The Report discusses various problems inherent in modifying the current tax structure to conform with either of the described alternative models, such as the treatment of capital gains accrued before but realized after the effective date for elimination of the current capital gains tax rules. Under the "Comprehensive Income Tax" model, the most difficult transition problem, according to the Report, would be the treatment of corporate earnings that remain undistributed as of the effective date of full corporate integration.

The Report describes two mechanisms available to alleviate transitional problems—"grandfathering" (exempting existing assets from new tax provisions) and gradual phasing-in of new rules—and makes specific proposals with respect to various of the proposed tax changes. As a general principle, the Report states, the transition rules in themselves must be designed with an objective of not introducing any major new complexity in the tax law.

The Report states that the problems raised by transition to the "Cash Flow Tax" model "would be considerable, and all of the alternative methods considered have major shortcomings." The plan proposed by the Report would maintain the present tax alongside the "Cash Flow Tax" for 10 years. During this period, individuals would compute tax liability under both systems and pay the higher of the two taxes. The corporate income tax would likewise be retained for the interim. Special rules would deal with the switchover at the end of the 10-year period.

2. *Treasury Department—1973 "Proposals for Tax Change"*

The "Proposals for Tax Change" issued by the Department of the Treasury in April 1973 recommended an approach to simplification of the individual income tax return designated as "reverse legislation", under which desired changes in the return are first identified, and then achieved through changes in the tax law. Following this approach, the Treasury developed a draft simplified return for use by the "average taxpayer." The draft return would progress in a straight line from items of income through items of deduction to a tax computation, eliminating most transfers from subsidiary schedules.

To permit utilization of this simplified return, the Treasury recommended the following tax law changes: (1) elimination of the dividends-received exclusion, the sick pay exclusion, and the deduction for State and local gasoline taxes; (2) aggregation of the medical expense and casualty loss deductions subject to a floor of 5 percent of adjusted gross income, with elimination of the special rules for deduction of medical insurance premiums and drugs and medicines; (3) addition of a $200 floor to the deduction for "miscellaneous" investment and employee business expenses; (4) addition for itemizers of a $500 "Miscellaneous Deduction Allowance"; and (5) simplification of the child care deduction, retirement income credit, and tax tables.

The simplification recommendations in the Treasury's 1973 report thus focused on curtailing use of itemized deductions (see Section V above).

3. *Treasury Department 1969 studies*

In February 1969, the Department of the Treasury issued a four-part study, which had been developed under the Johnson administration, entitled "Tax Reform Studies and Proposals." The Tax Reform Studies included recommendations to simplify the individual income tax by (1) increasing the standard deduction to reduce the number of taxpayers who itemize deductions; (2) placing a floor (3 percent of adjusted gross income) under the charitable contribution deduction, but making the deduction (as modified) available to non-itemizers; (3) repealing the deduction for State and local gasoline taxes; and (4) substantially revising tax rules applicable to elderly persons. These recommendations as such were not included in the "Tax Reform Proposals" submitted to Congress by the Treasury in April 1969.

4. General Accounting Office reports

The General Accounting Office is currently undertaking studies in the area of tax simplification at the request of the Joint Committee on Taxation. In a status report on its studies, the GAO has focused on two areas: (1) eight issues which have generated a significant level of controversy between taxpayers and the Internal Revenue Service at the Appellate Division level, and (2) simplification of the individual income tax through improvements in the forms and instructions and, where necessary, changes in the tax law. Statistical information from the status report is set forth in Section III of this report.

In an earlier report,[3] the GAO did a survey of lower-income taxpayers (adjusted gross income under $10,000) in six different locations. This survey showed that 70 percent of these taxpayers sought help in preparing their 1973 tax returns. While the GAO concluded that there was no clear need for the IRS to attempt to provide more complete tax return preparation assistance because of the existence of a large private tax return preparation industry, the GAO commented that the idea of a tax credit (instead of the present tax deduction) for the costs of private return preparation warrants more attention than it has received. The IRS expressed opposition to a credit for preparer fees on the grounds that it would add complexity to an already overly complex law and further complicate the tasks of return preparation and tax administration.

5. Federal Paperwork Commission

The Federal Paperwork Commission recently completed a study dealing with increasing the use of the short form return (Form 1040A), simplifying the reporting of farm income for individuals (Schedule F of Form 1040), utilizing taxpayer input in the development of tax forms and instructions, "piggybacking" of State income taxes, nontax administration items on IRS forms, reducing the number of income tax returns filed solely to obtain refunds of withholding, and simplifying the "Employer's Tax Guide" (Circular E).[4]

The recommendations of the Paperwork Commission are as follows:

(*a*) *Increasing the use of Short Form 1040A.*—The Commission made five recommendations for increasing the use of the short form income tax return. First, the IRS should develop and place into effect a program to encourage all eligible taxpayers to file income tax re-

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[3] General Accounting Office, "Internal Revenue Service Assistance to Taxpayers in Filing Federal Income Tax Returns" (April 1, 1976).

[4] Commission on Federal Paperwork, Final Report on Federal Taxation: Findings and Recommendations (June 1977).

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turns on Short Form 1040A. Second, the IRS should review each of the additional information requirements which preclude use of Short Form 1040A to see whether they could be resolved to permit expanded use of the simpler form. Third, the IRS should further simplify Short Form 1040A by eliminating all items not required by the IRS to determine tax liability. Fourth, the IRS should rewrite the instructions for preparing Short Form 1040A at a lower reading comprehension level. Fifth, the IRS should vigorously encourage wider taxpayer use of IRS tax computation by designing of the Short Form 1040A to emphasize ease of use when IRS computes tax; stressing the advantages of IRS computation in the instruction booklet, and by using public information channels to stress the advantages of having the IRS make the computations.

(*b*) *Reducing and simplifying some Federal income tax reporting for farmers.*—The Commission made two recommendations concerning the reporting requirements for farmers. First, the IRS should eliminate the filing of Schedule F (Form 1040) for farmers with low gross receipts from farm operations. For this purpose, the gross receipts would be set by IRS at a level compatible with a good compliance program. Second, the IRS should simplify Schedule F (Form 1040) by eliminating the detailed income and expense items and requiring only the insertion of gross and net amounts.

(*c*) *Taxpayer input in the development of tax forms and instructions.*—The Commission made three recommendations concerning the use of taxpayer input in developing forms. First, in addition to any notices required to be published in the *Federal Register*, the IRS should solicit comments concerning the forms and instructions in the various tax packages it sends to taxpayers. Second, the IRS should consider holding hearings concerning tax forms and instructions at several places in the country each year. Third, the IRS should solicit comments and suggestions on the current tax form and take these into account in the development of the subsequent year's forms and instructions.

(*d*) *Collection of State income tax by the Federal Government.*—The Commission recommended the prompt publication of proposed regulations under the "piggybacking" provisions of present law. The Commission also recommended legislation to trigger "piggybacking" upon the adoption by only a single State, eliminate tax filing population criteria for an election by a State for piggybacking, and prevent the imposition of a user charge upon States for administration of the piggybacking system. Finally, the Commission recommended the establishment of a permanent bipartisan commission relating to piggybacking.

(*e*) *Simplifying Circular E, "Employer's Tax Guide".*—The Commission recommended that the IRS should improve the employers' tax guide by rewriting it to make it more easily understood and by including additional material to assist employers in preparing the required forms and reports.

It was also recommended that the IRS should combine into one publication the payroll tax guide and the booklet containing supplies of employment tax forms. Since the latter must be issued in the summer to allow time for ordering tax forms before the end of the year, legislative changes late in the year affecting the withholding tables or other matters discussed in the guide can be dealt with in a separate document.

(f) *Other recommendations.*—The Commission also recommended actions to reduce the number of tax returns which are filed solely to obtain withholding refunds. A system of review of nontax items included on income tax forms was also recommended. The review system would involve the Internal Revenue Service, the Office of Management and Budget, and the General Accounting Office.

6. *Senate Select Committee on Small Business*

The Senate Select Committee on Small Business has proposed that (1) there be designated in the Department of Treasury a person whose assigned responsibilities include liaison with the small and independent business community in matters of tax policy; and (2) there be designated in the Congress, as part of the Joint Committee on Taxation, or otherwise, a person whose responsibilities include long-range tax simplification and tax reform having, as one of its objects, the small and independent business community.[5]

In addition, the committee suggested that, if quarterly employment tax filings (Forms 941 and 943) were changed to annual filings (as opposed to quarterly filings), a stack of paper 10,700 feet high—over 2 miles—each year could be eliminated from the reports that small business must fill out and mail, and which government agencies must process and store.[6] (See the discussion of Public Law 94–202 above which will partially achieve this objective.)

7. *Small Business Administration*

On June 3, 1977, the United States Small Business Administration issued a report which contained some recommendations relating to the simplification of the tax laws for small business. This study was made pursuant to Public Law 94–305.

Specifically, the study recommends for small business (1) a simplified LIFO inventory method, (2) a depreciation allowance for twice the amount allowable under the straight line method but with the repeal of the first-year bonus depreciation provision, and (3) an exemption from the depreciation recapture provisions.

In addition, the study suggests that there is a "bias" against small business which is created by the complexity of the tax system. In dealing with this problem, the study recommends that the Congress should (1) initiate a comprehensive study of the problems created by the multiplicity of taxes at various governmental levels, (2) set guidelines to determine employee status for payroll tax purposes, (3) provide a quick refund for overpayments of estimated taxes, (4) establish a program of tax education for operators of small businesses, and (5) allow court costs and attorney fees for successfully challenging the government in a tax dispute.

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[5] Senate Select Comm. on Small Business, 94th Cong., 1st Sess., Twenty-Sixth Annual Report 333 (1975) and Cong. Rec. S. 20545 (daily ed. Nov. 20, 1975).

[6] *Id.* at 89 and Senator Nelson's remarks upon introduction of Senate Resolution 306, Cong. Rec. S. 20545 (daily ed. Nov. 20, 1975).

[illegible]

VII. POSSIBLE BASE-BROADENING OPTIONS FOR THE INDIVIDUAL INCOME TAX

The provision directing the Joint Committee on Taxation to study simplification of the tax laws states: "Such study and investigation shall include a consideration of whether the rates of tax can be reduced by repealing any or all tax deductions, exemptions, or credits." (Sec. 507 of the Tax Reform Act of 1976.)

This part of the study carries out that directive by quantifying the amount of rate reduction possible in the individual income tax with four levels of base-broadening ranging from a relatively minor change to a very comprehensive revision. The first three options (A, B, and C) deal only with simplification in that they deal with the impact of eliminating existing deductions and special exclusions listed on the tax return and do not require the inclusion of income items currently not reported. Option D adds to option C the excluded income items or deduction items for individuals marked with an asterisk in Appendix A, "Estimates of Federal Tax Expenditures," to show the further rate reduction possible with additional base broadening that may actually add some degree of complexity due to the inclusion of items not presently on the tax return.

These base-broadening options are intended to be only illustrative of the degree of rate reduction associated with various levels of base-broadening. They are not intended as recommendations and do not represent the views of the staff or the Joint Committee as to what is desirable.

The three simplification base-broadening options are described in table 1 below. They range from option A which eliminates only a few exclusions, deductions and credits to option C which eliminates most of the itemized deductions and exclusions from income reported on the tax return. Option B is an arbitrary intermediate step between options A and C. As noted above, option D is the same as option C plus the presently excluded income items indicated on the tax expenditure list.

For example, as shown in table 11 below, option A would eliminate the dividend and disability income exclusion and the itemized deductions for State gasoline taxes, contributions and appreciated property, and political contributions. It would combine all deductions for medical expenses, casualty losses, and miscellaneous deductions, and impose a floor of 5 percent of adjusted gross income (AGI). In addition, it would eliminate the 2 percent of taxable income credit and the alternative capital gains tax computation. Option B, in addition to the items in option A, would eliminate the special treatment of capital gains, eliminate the itemized deduction for State sales, personal property, and miscellaneous taxes, and would limit the deduction for investment interest to the amount of investment income. It would also impose a floor on charitable contributions of 5 percent of AGI. The treatment of the medical, casualty loss, and miscellaneous deductions would be the same as under option A except that the floor would be 10 percent of AGI. In addition, it would eliminate the tax credit for the elderly and the maximum and minimum tax computations.

Option C, in addition to the items in option B, would eliminate the exclusion/deduction for moving expenses and the deduction for individual retirement accounts. It would also eliminate the deduction for State income taxes and would eliminate the deduction for all interest payments other than those for investment purposes (which would be limited to the amount of investment income). It would eliminate the deduction for all charitable contributions and all of the medical casualty loss and miscellaneous deductions categories. It would eliminate the child care credit, and all other credits except those for business purposes (the investment and foreign tax credits).

Without rate reduction, the base-broadening of options A, B and C would raise \$8.0, \$30.1, and \$47.1 billion, respectively, as shown in column 1 of table 12 below. These amounts represent 5.0, 18.6, and 29.2 percent, respectively, of the \$161.4 billion tax of present law. (Options B and C would involve decreases of \$1.9 billion and \$1.5 billion in column 3 because of the repeal of the minimum tax and the capital loss limitation.)

Returns switching to the standard deduction under the respective options would be 3.2, 13.4, and 21.5 million (last column, table 2). This would raise the percentage of returns using the standard deduction from the present law 75 percent to 78, 90, and 99 percent, respectively.

Table 11.—Three Possible Base-Broadening Options for the Individual Income Tax

[× indicates the provision that would be repealed under the indicated option unless a limitation is to be imposed]

Provision	Option		
	A	B	C
Exclusions:			
Dividend	×	×	×
Disability income	×	×	×
Capital gains		×	×
Moving expenses			×
IRA (individual retirement account)			×
Itemized deductions:			
State gas tax	×	×	[2]
State sales tax		×	[2]
Personal property tax		×	[2]
Miscellaneous taxes		×	[2]
All taxes			×
Limit investment interest to investment income		×	[2]
All interest deductions other than investment (up to investment income)			×
Contributions of appreciated property	×	×	[2]
Impose a floor on contributions of 5 percent of AGI		×	[2]
Political contributions deduction	×	×	[2]
All contributions			×
Combine all medical, casualty losses, and miscellaneous under floors of:			
5 percent of AGI	×		[2]
10 percent of AGI		×	[2]
Medical, casualty losses, and miscellaneous deductions			×
Credits:			
2 percent taxable income	×	×	[2]
Child care			[2]
Elderly		×	[2]
All credits (except business)[1]			×
Tax computation:			
Alternative treatment of capital gains	×	×	×
Maximum tax		×	×
Minimum tax		×	×

[1] Investment credit and foreign tax credit.
[2] Item would also be eliminated under a comprehensive change affecting all such deductions or credits.

Table 12.—Estimated Impact of Three Base-Broadening Options, 1977 Law and Income Level

	Tax change (billion dollars)			Returns (millions)				
				With		Made		Switching to standard deduction
	Net	Increase	Decrease	Increase	Decrease	Taxable	Nontaxable	
Without rate reduction:								
Option A	$8.0	$8.0	$0	53.2	0	0.3	0	3.2
Option B	30.1	32.0	−1.9	59.7	.9	1.9	.2	13.4
Option C	47.1	48.6	−1.5	72.1	.7	5.0	.2	21.5
With rate reduction:								
Option A	.3	2.5	−2.1	24.7	40.8	.2	.2	3.2
Option B	−.6	12.8	−13.4	19.2	51.1	1.7	.5	13.4
Option C	.1	15.4	−15.3	28.8	43.9	4.9	.2	21.5

The base-broadening in option A allows rate reduction of only one percentage point in each marginal rate, making the rates range from 13 to 69 percent. Option B would increase tax liability by 19 percent and would permit rates to be reduced to a range from 12 to 60 percent. Option C would increase tax by 29 percent from base-broadening and would permit a roughly proportional reduction in rates to a range of 11 to 50 percent. (See Table 14 below.) The rate schedule for option C is shown in table 14 below. Option D, which includes approximately $49 billion of additional tax from tax expenditure items, would raise a total of $96 billion from base-broadening, a tax increase of 59 percent, which would permit roughly proportional reduction of tax rates to a range of 8 to 35 percent.

Table 13.—Percentage Tax Change From Base-Broadening and Range of Tax Rates for Neutral Revenue Effect

Option	Percentage tax change	Range of tax rates
A	5	13 to 69
B	19	12 to 60
C	29	11 to 50
D	59	8 to 35

More detail on the impact of options A, B, and C is shown in tables 15 through 17 below. These tables show, by adjusted gross income classes, the number of returns with tax increase, the amount of tax increase, the net tax change and the percentage tax change.

These tables are the result of computer runs using the revised rate schedules. The rates were computed to the nearest whole percentage point; thus, precise revenue neutrality could not be achieved. The rate cuts were proportional except for the top rate. No attempt was made to return the same amount of revenue from rate cuts to the same income classes from which it was obtained from base-broadening.

Table 14.—Rate Table for Married Individuals Filing Joint Returns and Certain Surviving Spouses Under Present Law and Option C

Taxable income		Tax		Tax rate (percent)		
Over	Not Over	Present law	Option C	Present law	Option C	On excess over
---------	$3, 200	0	0	—	—	—
$3, 200	4, 200	0	0	14	11	$3, 200
4, 200	5, 200	$140	110	15	12	4, 200
5, 200	6, 200	290	230	16	13	5, 200
6, 200	7, 200	450	360	17	14	6, 200
7, 200	11, 200	620	500	19	15	7, 200
11, 200	15, 200	1, 380	1, 100	22	17	11, 200
15, 200	19, 200	2, 260	1, 780	25	19	15, 200
19, 200	23, 200	3, 260	2, 540	28	22	19, 200
23, 200	27, 200	4, 380	3, 420	32	25	23, 200
27, 200	31, 200	5, 660	4, 420	36	28	27, 200
31, 200	35, 200	7, 100	5, 540	39	30	31, 200
35, 200	39, 200	8, 660	6, 740	42	32	35, 200
39, 200	43, 200	10, 340	8, 020	45	35	39, 200
43, 200	47, 200	12, 140	9, 420	48	37	43, 200
47, 200	55, 200	14, 060	10, 900	50	39	47, 200
55, 200	67, 200	18, 060	14, 020	53	41	55, 200
67, 200	79, 200	24, 420	18, 940	55	43	67, 200
79, 200	91, 200	31, 020	24, 100	58	45	79, 200
91, 200	103, 200	37, 980	29, 500	60	46	91, 200
103, 200	123, 200	45, 180	35, 020	62	47	103, 200
123, 200	143, 200	57, 580	44, 420	64	48	123, 200
143, 200	163, 200	70, 380	54, 020	66	49	143, 200
163, 200	183, 200	83, 580	63, 820	68	50	163, 200
183, 200	203, 200	97, 180		69		183, 200
203, 200		110, 980		70		203, 200

Option A (as shown in table 15) would provide a tax decrease of $2.1 billion to about 41 million returns and a tax increase of about $2.5 billion to 25 million returns. Option B (table 16), would provide a tax decrease of $13.4 billion to 51 million returns and a tax increase of $12.8 billion to 19 million returns. Option C (table 17), would provide a tax decrease of $15.3 billion to 44 million returns and a tax increase of $15.4 to about 29 million returns. The amount of tax increase and tax decrease and the number of returns with increases and decreases are not available for option D because the tax expenditure items are not on the computer and are not matched with tax returns.

Table 15.—Base-Broadening Option A: Estimated Revenue Effect at 1977 Income Levels

Income (AGI) class (thousands)	Returns with tax decrease (thousands)	Amount of tax decrease (millions)	Returns with tax increase (thousands)	Amount of tax increase (millions)	Net tax change (millions)	Percentage tax change
$0–5	4, 360	−$48	479	$58	$10	([1])
5–10	10, 102	−208	6, 052	121	−87	−1. 1
10–15	7, 456	−277	7, 392	318	41	. 2
15–20	8, 159	−383	3, 812	261	−122	−. 5
20–30	7, 339	−582	4, 495	473	−109	−. 3
30–50	2, 502	−334	1, 919	362	28	. 1
50–100	732	−210	445	270	60	. 3
100 plus	144	−96	154	600	504	2. 6
Total	40, 794	−2, 138	24, 749	2, 473	325	. 2

[1] Note that the percentage tax changes in the under $5,000 AGI class are not meaningful because when the refundable part of the earned income credit is taken into account the tax under present law is negative and small, −$100 million. A more meaningful comparison is tax as a percent of income. Adjusted gross income in this class is $61.1 billion. Thus, a $10 million net tax change (table 4, option A) would be 10 percent of tax increase, which looks large, but that is only 0.02 percent of income.

Table 16.—Base-Broadening Option B: Estimated Revenue Effect at 1977 Income Levels

Income (AGI) class (thousands)	Returns with tax decrease (thousands)	Amount of tax decrease (millions)	Returns with tax increase (thousands)	Amount of tax increase (millions)	Net tax change (millions)	Percentage tax change
$0–5	4, 118	−$93	3, 686	$954	[1] $861	([1])
5–10	12, 973	−781	4, 878	919	138	1. 7
10–15	12, 096	−1, 695	2, 823	920	−776	−4. 4
15–20	9, 479	−2, 450	2, 511	919	−1, 531	−6. 3
20–30	8, 725	−3, 513	3, 125	1, 645	−1, 868	−4. 6
30–50	2, 857	−2, 261	1, 568	2, 165	−97	−1. 3
50–100	698	−1, 559	481	1, 931	372	1. 8
100 plus	140	−1, 007	158	3, 322	2, 315	11. 8
Total	51, 085	−13, 359	19, 230	12, 774	−585	−1. 4

[1] *Ibid*, table 14.

Table 17.—Base-Broadening Option C: Estimated Revenue Effect at 1977 Income Levels

Income (AGI) class (thousands)	Returns with tax decrease (thousands)	Amount of tax decrease (millions)	Returns with tax increase (thousands)	Amount of tax increase (millions)	Net tax change (millions)	Percentage tax change
$0–5	1, 810	−$26	$7, 381	$1, 095	$1, 069	([1])
5–10	10, 123	−664	8, 553	1, 487	823	10. 4
10–15	10, 456	−1, 627	4, 590	1, 406	−222	−1. 3
15–20	9, 134	−2, 589	2, 861	1, 180	−1, 408	−5. 8
20–30	8, 780	−4, 433	3, 077	2, 075	−2, 358	−5. 8
30–50	2, 838	−2, 899	1, 590	2, 575	−323	−1. 1
50–100	637	−1, 747	543	2, 348	602	2. 8
100 plus	140	−1, 314	158	3, 254	1, 940	10. 0
Total	43, 918	−15, 299	28, 753	15, 420	121	. 1

[1] Ibid, table 14.

APPENDICES

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APPENDIX A, ESTIMATES OF FEDERAL TAX EXPENDITURES

TAX EXPENDITURE[4] ESTIMATES BY FUNCTION AND SUBFUNCTION[1]

[Fiscal years; in millions of dollars]

Function and subfunction	Corporations						Individuals					
	1977	1978	1979	1980	1981	1982	1977	1978	1979	1980	1981	1982
NATIONAL DEFENSE												
Military personnel:												
*Exclusion of benefits and allowances to Armed Forces personnel							1,095	1,260	1,360	1,470	1,585	1,715
*Exclusion of military disability pensions							105	115	120	130	135	145
INTERNATIONAL AFFAIRS												
International financial programs:												
*Exclusion of income earned abroad by U.S. citizens							120	135	150	160	170	185
Deferral of income of domestic international sales corporations (DISC)	1,030	1,190	1,360	1,455	1,475	1,545						
Deferral of income of controlled foreign corporations	410	410	410	410	410	410						
Special rate for Western Hemisphere trade corporations	35	25	15	5								

APPENDIX A, ESTIMATES OF FEDERAL TAX EXPENDITURES—Continued

TAX EXPENDITURE [4] ESTIMATES BY FUNCTION AND SUBFUNCTION [1]—Continued

[Fiscal years; in millions of dollars]

Function and subfunction	Corporations 1977	1978	1979	1980	1981	1982	Individuals 1977	1978	1979	1980	1981	1982
NATURAL RESOURCES, ENVIRONMENT, AND ENERGY												
Conservation and land management:												
Capital gains treatment of certain timber income	300	325	340	355	375	395	95	100	105	110	115	125
Pollution control and abatement:												
Exclusion of interest on State and local government pollution control bonds	170	220	265	300	330	355	75	100	125	145	160	175
Exclusion of payments in aid of construction of water and sewage utilities	15	10	10	10	10	10						
5-year amortization on pollution control facilities	−80	−130	−45	40	130	180						
Energy:												
*Expensing of exploration and development costs	610	600	610	635	675	735	105	150	155	185	200	230
Excess of percentage over cost depletion	1, 035	1, 060	1, 135	1, 220	1, 295	1, 360	275	300	330	360	400	410
Other natural resources: Capital gains treatment of royalties on coal and iron ore	20	20	25	25	30	30	45	50	60	70	80	90
AGRICULTURE												
Farm income stabilization:												
Capital gains treatment of certain ordinary income	10	15	15	15	15	15	330	350	365	385	405	425
*Expensing of certain capital outlays	80	70	75	80	80	85	370	440	460	475	490	510
*Deductibility of noncash patronage dividends and certain other items of farm cooperatives	455	490	535	570	610	655	−165	−170	−180	−190	−200	−210

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Mortgage credit and thrift insurance:												
Exemption of credit union income	165	185	200	225	250	275						
Excess bad debt reserves of financial institutions	560	645	860	875	945	925						
Deductibility of mortgage interest on owner-occupied homes							5, 435	6, 030	6, 695	7, 430	8, 250	9, 160
Deductibility of property tax on owner occupied homes							4, 500	4, 995	5, 545	6, 155	6, 830	7, 580
Deductibility of interest on consumer credit							2, 310	2, 565	2, 845	3, 160	3, 505	3, 895
Credit for purchase of new homes							100					
*Deferral of capital gains on home sales							890	935	980	1, 030	1, 080	1, 135
Other advancement and regulation of commerce:												
Dividend exclusion							410	425	450	470	495	520
Corporate surtax exemption	4, 650	4, 250	3, 655	3, 915	4, 205	4, 485						
Capital gains (other than farming, timber, iron ore and coal)	555	550	550	585	615	650	7, 030	7, 360	7, 710	8, 265	8, 855	9, 495
*Capital gains at death							7, 280	8, 120	8, 975	9, 910	10, 945	12, 090
*Depreciation on rental housing in excess of straightline	100	100	105	105	105	105	405	425	450	470	490	515
*Depreciation on buildings (other than rental housing) in excess of straight line	210	200	190	185	180	175	185	175	170	165	160	155
*Expensing of research and development expenditures	1, 395	1, 450	1, 520	1, 610	1, 695	1, 715	30	30	30	30	35	35
*Exclusion of interest on State and local industrial development bonds	195	235	270	315	355	400	90	110	130	150	170	190
*Excess first-year depreciation	45	45	50	50	55	55	135	145	155	160	170	180
*Expensing of construction period interest and taxes	475	500	525	555	585	615	150	140	90	140	160	205
Investment credit	8, 640	9, 670	10, 375	10, 910	9, 380	7, 380	1, 970	2, 205	2, 430	2, 595	2, 595	1, 725
*Asset depreciation range	1, 630	1, 825	2, 000	2, 095	2, 115	2, 115	175	195	220	230	235	235

APPENDIX A, ESTIMATES OF FEDERAL TAX EXPENDITURES—Continued

TAX EXPENDITURE [4] ESTIMATES BY FUNCTION AND SUBFUNCTION [1]—Continued

[Fiscal years; in millions of dollars]

Function and subfunction	Corporations						Individuals					
	1977	1978	1979	1980	1981	1982	1977	1978	1979	1980	1981	1982
Ground transportation:												
5-year amortization on railroad rolling stock	−35	−40	−40	−40	−40	−40						
Deductibility of nonbusiness State gasoline taxes							795	880	980	1,085	1,205	1,340
Water transportation: Deferral of tax on shipping companies	90	70	60	50	40	35						
COMMUNITY AND REGIONAL DEVELOPMENT												
Community development:												
5-year amortization for housing rehabilitation	10	5	5	(2)	(2)	−5	20	10	5	(2)	(2)	−5
Tax incentives for preservation of historic structures	(2)	(2)	5	5	5	5	(2)	(2)	5	5	10	10
EDUCATION, TRAINING, EMPLOYMENT, AND SOCIAL SERVICES												
Higher education:												
*Exclusion of scholarship and fellowship income							250	285	375	400	420	445
*Parental personal exemption for students age 19 or over							750	770	790	815	840	865
Deductibility of charitable contributions (education)	215	240	265	300	335	365	540	565	595	625	655	690

Training and employment:												
Credit for child- and dependent-care expenses							840	870	960	1, 050	1, 155	1, 270
Deduction for eliminating barriers for the handicapped	5	10	10	5	(2)	(2)						
5-year amortization on child-care facilities	(2)	(2)	(2)	(2)	(2)	(2)						
Credit for employment of AFDC recipients and public assistance recipients under work incentive programs	15	15	20	20	20	20						
Other labor services:												
*Exclusion of employee meals and lodging (other than military)							330	350	370	395	420	445
Maximum tax on personal service income							730	855	1, 025	1, 235	1, 480	1, 775
*Exclusion of contributions to prepaid legal services plans							5	10	15	20	35	50
Investment credit for ESOP's	245	255	305	330	190							
Social services: Deductibility of charitable contributions to other than education and health	270	295	330	370	415	450	3, 985	4, 510	5, 100	5, 755	6, 490	7, 310
HEALTH												
Health-care services:												
*Exclusion of employer contributions for medical insurance premiums and care							5, 195	5, 810	6, 560	7, 375	8, 290	9, 320
Deductibility of medical expenses							2, 585	2, 870	3, 185	3, 535	3, 920	4, 355
Health research and education: Deductibility of charitable contributions (health)	135	150	165	185	205	225	915	965	1, 010	1, 060	1, 115	1, 170

APPENDIX A, ESTIMATES OF FEDERAL TAX EXPENDITURES—Continued

TAX EXPENDITURE [4] ESTIMATES BY FUNCTION AND SUBFUNCTION [1]—Continued

[Fiscal years; in millions of dollars]

Function and subfunction	Corporations						Individuals					
	1977	1978	1979	1980	1981	1982	1977	1978	1979	1980	1981	1982
INCOME SECURITY												
General retirement and disability insurance:												
Exclusion of social security benefits:												
*Disability insurance benefits							380	430	435	540	600	665
*OASI benefirs for retired workers							3, 125	3, 450	3, 795	4, 155	4, 500	4, 870
*Benefits for dependents and survivors							730	795	875	955	1, 035	1, 120
*Exclusion of railroad retirement system benefits							200	205	215	220	230	235
*Exclusion of workmen's compensation benefits							705	810	935	1, 070	1, 235	1, 420
*Exclusion of special benefits for disabled coal miners							50	50	50	55	55	55
Net exclusion of pension contributions and earnings:												
Employer plans							8, 715	9, 940	11, 335	12, 925	14, 740	15, 815
Plans for self-employed and others							1, 305	1, 535	1, 760	2, 025	2, 325	2, 670
Exclusion of other employee benefits:												
Premiums on group term life insurance							800	835	870	900	940	975
*Premiums on accident and accidental death insurance							70	75	80	85	85	95
Exclusion of capital gains on home sales for persons age 65 and over							40	70	70	70	70	75
Additional exemption for elderly							1, 220	1, 280	1, 345	1, 410	1, 480	1, 555
Tax credit for the elderly							495	440	435	430	425	420

*Exclusion of interest on life insurance savings							1, 815	1, 995	2, 185	2, 400	2, 630	2, 885
Exclusion of sick pay							50	55	68	60	65	70
Unemployment insurance:												
*Exclusion of unemployment insurance benefits							2, 745	2, 445	2, 240	2, 125	2, 070	2, 035
*Exclusion of income of trusts to finance supplementary unemployment benefits							10	10	10	10	10	10
Public assistance: *Exclusion of public assistance benefits							100	105	110	115	125	130
Excess of percentage standard deduction over minimum standard deduction							1, 285	1, 410	1, 555	1, 710	1, 880	2, 070
Additional exemption for the blind							20	20	20	20	20	20
Earned income credit:												
Nonrefundable portion							395	380				
Refundable portion							1, 015	970				
Deductibility of casualty losses							345	380	425	470	520	580
VETERANS BENEFITS AND SERVICES												
Income security for veterans:												
*Exclusion of veterans disability compensation							655	690	690	685	685	685
*Exclusion of veterans pensions							30	35	35	35	35	35
Veterans education, training, and rehabilitation: Exclusion of GI bill benefits							225	240	220	190	160	135
GENERAL GOVERNMENT												
Other general government: Credits and deductions for political contributions							40	35	40	40	45	45
REVENUE SHARING AND GENERAL PURPOSE FISCAL ASSISTANCE												
Other general purpose fiscal assistance:												
*Exclusion of interest on general purpose State and local debt	3, 105	3, 470	3, 865	4, 305	4, 780	5, 310	1, 680	1, 880	2, 095	2, 335	2, 595	2, 880

APPENDIX A, ESTIMATES OF FEDERAL TAX EXPENDITURES—Continued

TAX EXPENDITURE [4] ESTIMATES BY FUNCTION AND SUBFUNCTION [1]—Continued

[Fiscal years; in millions of dollars]

Function and subfunction	Corporations 1977	1978	1979	1980	1981	1982	Individuals 1977	1978	1979	1980	1981	1982
Tax credit for corporations doing business in U.S. possessions [3]	285	310	330	350	370	390						
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline)							8, 095	8, 990	9, 975	11, 075	12, 290	13, 645
INTEREST												
*Interest on the public debt: Deferral of interest on savings bonds							565	625	685	755	820	890

[1] All estimates are based on the Internal Revenue Code as of Jan. 1, 1977.

[2] Less than $2,500,000.

[3] Includes the effect of sec. 931 exclusion for individuals doing business in certain U.S. possessions.

[4] Tax expenditure data are intended to show the cost to the Federal Government, in terms of revenues it has foregone, from tax provisions that either have been enacted as incentives for the private sector of the economy or have that effect even though initially having a different objective. The tax incentives usually are designed to encourage certain kinds of economic behavior as an alternative to employing direct expenditures or loan programs to achieve the same or similar objectives. These provisions take the form of exclusions, deductions, credits, preferential tax rates, or deferrals of tax liability. For purposes of the tax expenditure reports, a tax expenditure is described as a tax incentive that departs from simply allowing as deductions from gross income the costs incurred in earning net income. This allows deductions for current expenditures directly related to the process of earning income, and therefore these expenditures are not treated as tax expenditures.

NOTE.—Limitations on the use of totals are explained in the text:

SUM OF THE TAX EXPENDITURE ITEMS BY TYPE OF TAXPAYER AND FISCAL YEAR*

[In millions of dollars]

Fiscal year	Corporations and individuals	Corporations	Individuals
1977	114, 470	27, 050	87, 465
1978	124, 395	28, 740	95, 710
1979	133, 865	30, 370	103, 545
1980	146, 285	32, 425	113, 935
1981	157, 460	32, 240	125, 280
1982	168, 465	31, 425	137, 100

*These totals represent the mathematical sum of the estimated fiscal year effect of each of the 85 tax expenditure items included in this table.

Source: Staffs of the Treasury Department and the Joint Committee on Taxation

APPENDIX B. SURVEY OF RECENT LITERATURE RELATING TO TAX SIMPLIFICATION

A. Introduction

While many comprehensive studies of the Federal income tax system have touched upon problems of complexity, relatively few analyses have focused primarily on that aspect of the tax laws. This section of the Report [1] summarizes several commentaries published during the last ten years which analyze the obstacles to achieving simplicity without undue sacrifice of other tax law objectives and which suggest steps toward simplification.

The tax experts whose articles have been briefly summarized below include Boris I. Bittker,[2] professor of law at Yale University, James S. Eustice,[3] New York University, and Stanley S. Surrey,[4] Harvard University, together with various authors of a 1969 symposium on tax reform published by Duke University [5] and a "Report on Complexity and the Income Tax" issued in 1972 by the New York State Bar Association's Committee on Tax Policy.[6] The views outlined below are grouped by topic—structural factors and basic policies contributing to complexity; responsibilities for complexity asserted to rest with the Congress, the Treasury, the courts, and tax practitioners; and signs of progress.

B. Structural Causes of Complexity

Most commentators have concluded that one or more aspects of the tax structure in the United States inherently give rise to complexity. These structural causes of complexity are said to include the tax base, timing of the tax, the taxable unit, the progressive rate structure, and the several political jurisdictions having power to tax the same income.

Professor Surrey has observed that, in addition to supplying most Federal revenues, the income tax affects most areas of economic and

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[1] This section is based on a report prepared at the Joint Committee's request by Harry G. Gourevitch, Senior Specialist in Taxation and Fiscal Policy, and Marie B. Morris, Legislative Attorney, American Law Division, Congressional Research Service of the Library of Congress.

[2] Bittker, *Tax Reform and Tax Simplification*, 29 U. Miami L. Rev. 1–20 (1975).

[3] Eustice, *Tax Complexity and the Tax Practitioner*, 8 Tax Adviser 27–35 (January 1977).

[4] Surrey, *Complexity and the Internal Revenue Code: The Problem of Management of Tax Detail*, 34 Law and Contemporary Problems 673–710 (1969).

[5] Symposium on *Tax Simplification and Reform*, 34 Law and Contemporary Problems (1969) [hereinafter cited as 1969 Symposium].

[6] Committee on Tax Policy of the Tax Section of the New York State Bar Association, *A Report on Complexity and the Income Tax*, 27 Tax L. Rev. 325–376 (1972).

social life. Particularly in light of its pervasive nature, the tax has four characteristics which tend to produce complexity:

(1) the tax falls on net income;
(2) it is assessed yearly;
(3) it applies to discrete taxable units; and
(4) it has progressive rates.

The tax law is necessarily detailed and complex, Professor Surrey states, because it must cope with and define these characteristics. Thus, defining and measuring net income involve complex considerations of how individuals and corporations spend funds and which expenditures should be relevant for income tax purposes, especially since these measurements must be made annually. The categories of taxable units involve complexity and invite tax manipulations. Finally, the progressive rate structure complicates the allocation of income among taxable units, such as family members or a business entity and its owners.

Professor Surrey describes the "tax expenditure" apparatus as vast both in the kinds of activities aided and in the methods chosen to provide the incentives. As a result, complexity is compounded by the necessity to classify certain income as being entitled to special preferences. In some situations, such as partnerships, trusts, or subchapter S corporations, this classification or subclassification must be traced through the original return to the return of each partner, beneficiary, or shareholder. Professor Surrey states: "This subclassification is a serious source of technical complication, which could be avoided if the unitary concept of gross income were not so seriously undercut by these schedular enclaves necessitated by the tax expenditures."

Professor Eustice writes that fundamental tax reform which would lower rates and broaden the tax base would definitely contribute to simplification. Accordingly, he suggests that the 50-percent maximum tax on earned income could be expanded. He also suggests that consideration be given to a split-tier tax system, with a "simple" tax for most taxpayers, and the "complexity game" retained for others who so elect. In addition, he states that a floor under itemized deductions would lessen complexity, for example, by allowing a deduction only for "extraordinary" charitable contributions. Professor Eustice likewise cites the tax base, taxable period, taxable unit, and progressive rate structure as inevitable causes of complexity in light of the country's size and economic system.

Laurence N. Woodworth, Assistant Secretary of the Treasury for Tax Policy, has stated [7] that tax simplification, even though one of the major objectives of tax reform, has proved difficult to achieve, principally because simplicity may be sacrificed, if it conflicts with objectives thought more important or with economic or fiscal goals. He also notes that complex problems involving sophisticated taxpayers may necessitate complex solutions, and that reform measures often call for complicated transition rules to allow taxpayers time to adjust to the new law.

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[7] Woodworth, *Tax Simplification and the Tax Reform Act of 1969*, 1969 Symposium at 711–25.

To eliminate some of the complexity caused by questions of timing, William Vickrey (Professor of Economics, Columbia University) has proposed the use of cumulative averaging concepts, under which an individual's income tax would be assessed on the basis of aggregate income over a period extending from some fixed initial year to the current year.[8]

Under this proposal, any shifting of items of income or deductions from one year to another within the overall period would have no effect on tax liability. Accruals of income as of the end of the averaging period would be included in the tax base in order to prevent an individual from shifting income into or out of the averaging period, but within this period an individual would be free to choose such matters as rate of depreciation and expensing or capitalizing of outlays. Professor Vickrey's proposal combines cumulative averaging with full taxation of capital gains and full deduction of capital losses, thereby permitting repeal of a significant number of provisions of the Internal Revenue Code.

C. Basic Policies Which Contribute to Tax Complexity

Policies which commentators have identified as contributing to complexity include the desire for tax equity, use of the tax system for nonrevenue purposes, separate tax treatment of corporations and shareholders, lower tax rates for capital gains, and high progressive rates.

According to Professor Surrey, the preferential treatment of capital gains may be the chief contributor to statutory complexity. This special treatment necessitates definitions of "capital gain" which can differentiate all forms of ownership and classify all income-producing transactions as either capital gain or ordinary income. Other complexities result because capital gains are not taxed until they are "realized". This postpones the tax while the asset increases in value and allows the potential tax liability to increase, thereby creating pressures to delay "realization." Because of these pressures, certain realized gains are not "recognized" until later transactions with the same assets. Similarly, capital losses are realized and recognized to differing extents depending on the classification of the asset and transaction.

Professor Surrey also points out that the policy of treating corporations as taxable entities and separately taxing shareholders on dividends distributed by the corporation has required development of a series of technical rules on the treatment of distributions by corporations to their shareholders. When compounded with the capital gains concept, these rules become very complex. The progressive individual rate structure results in additional complexity, but. Professor Surrey notes, other commentators have said that a broad-based flat-rate tax would not necessarily produce fewer complexities.

Similarly, Commissioner of Internal Revenue Jerome Kurtz recently pointed out how two goals of the tax system, economic equity, and encouragement of socially desirable objectives, have been pursued at

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[8] Vickrey, *Tax Simplification Through Cumulative Averaging*, 1969 Symposium at 736–50.

the price of greater tax complexity.[9] As one example of the trade-off between equity and simplicity, he compares the social security tax, which raised approximately $80 billion in 1976, with the income tax, which raised about $173 billion. The social security tax is a simple tax, a flat levy on gross wages, comprised of equal amounts withheld from employees' salaries and contributed by employers. For 1977, only the first $16,500 of salary is taxed. There are no personal exemptions, deductions, or credits; family size is irrelevant. There are very few technical problems or disputes. The tax is simple to administer but regressive in its application because the more total income one has over the $16,500 ceiling, the lower the effective rate of tax. In contrast, the income tax attempts a more refined and equitable definition of ability to pay. Each refinement and attempt to reach this goal adds complexity, Commissioner Kurtz notes.

Commissioner Kurtz also states that the tax expenditure provisions are another major cause of complexity. He notes that, according to commentators, these items have produced the greatest amount of complexity and that eliminating them would have little or no cost in decreased equity. The Commissioner observed that there are about 80 separate tax expenditure provisions in the Code in the form of deductions, credits, exclusions from gross income, and preferential tax rates, each provision having its own set of issues, definitions, and limitations. Not only have these expenditures eroded the tax base, he declares, but they have generated administrative problems and have made enforcement of the tax laws increasingly difficult.

In addition to the reduced rates for capital gains, progressive rate structure, separation of corporations and shareholders, and tax expenditure apparatus, Yale's Professor Bittker mentions two other policies which contribute to tax complexity. He suggests that if the concept of realization were abandoned and taxpayers were required to value their assets annually, many complexities would vanish such as the elaborate rules governing nontaxable exchanges, the separate tax status of corporations, and the distinction between business expenses and capital outlays.

Professor Bittker also asserts that cash basis accounting permits various deferral devices by providing opportunities to postpone recognition of income. Attempts to prevent this tax avoidance have introduced some statutory complexity. But while the tax law could be simplified by requiring accrual basis accounting, he concludes, the taxpayer's compliance burden would be severely complicated.

D. The Congress as a Source of Complexity

1. The legislative process

Of the institutional causes of tax complexity (i.e., the Congress, Treasury, the courts, and the tax profession), the Congress appears to have received the most attention from commentators.

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[9] Kurtz, *Tax Simplification: Some Observations from a Retrospective View of the United States' Experience*, speech delivered May 9, 1977, in Caracas, Venezuela, before the 11th General Assembly of the Interamerican Center of Tax Administrators (reprinted in 123 Cong. Rec., S8349–S8352) (daily ed. May 23, 1977)).

Professor Eustice suggests that the Congress, as the ultimate source of all tax legislation, bears primary responsibility for complexity in the tax law. More particularly, he suggests that the Congress may not always be aware of the technical implications of tax provisions it writes, that conflicting interests represented by various special interest lobbyists and the Treasury present decisional difficulties and that time pressures may result in undue haste in enacting complex provisions. As a result, the tax law has become overloaded with provisions designed to promote social and economic goals.

Professor Eustice states that simplification would be served if the Congress would stop its "incessant tinkering" with the Internal Revenue Code and if it would not attempt broadscale substantive reform whenever legislating in the tax area. He cautions against Congress' trying to do too much at one time, and suggests that the Congress instead should review and rewrite specific areas of the law following thorough technical analysis by experts, such as the "Advisory Group" reports on subchapters C, J, and K in the late 1950s.

The New York State Bar Association's Committee on Tax Policy describes the legislative process itself as a key element in tax complexity. Rather than assuming a leadership role, the Congress responds to pressure, according to the committee's report. Both the executive branch and constituents pressure the Congress to examine particular problems in disregard of larger perspectives. This results in conflicting policies and a failure to focus on the structure of the tax law.

The committee asserts that political compromises also create complexity, and that even efforts to reform the law may result in compromises more complicated than the original provision, with loopholes narrowed but not closed. As examples of complexity resulting from "overreaction" to a particular abuse, the committee cited the private foundation and charitable contribution deduction rules of the 1969 Tax Reform Act.

The committee states that time pressures on the Congress contribute to complexity by allowing too little time for research and review of the drafting to ensure that the needs for simplicity and comprehensible structure are met. Errors take time to correct, and corrections may be made only in response to pressure from taxpayers and the executive branch.

The committee's report recommends creation of a permanent agency under the aegis of, but politically independent from, the Congress. The agency could initiate and draft legislative proposals.

Professor Surrey makes these comments on the legislative process:

> Under our legislative system, the pulling and hauling between Executive and Congress, between the tax committees and the parent legislative bodies, between the House and Senate, between lobbyists for the private sector and the lobbyists for the Executive, between one group of private lobbyists and another group, and so on, can yield ultimate legislative decisions which provide disorderly patterns of tax structure. There is no commanding voice to bring order out of these many and often simultaneous struggles. The result is bound to be more rather than less complexity in a tax system.[10]

[10] Surrey, *supra*, at 690.

Also, Professor Surrey mentions several attempts at tax reforms (e.g., with respect to travel and entertainment expenses, foreign income taxation, and capital gains treatment) where the final result was a compromise more complicated than the prior law or the proposed reform, noting: [11]

> No taxpayer group ever rejects a new tax preference on the ground that it is complex. Nor does a group seeking to retain an existing tax preference reject a compromise solution because of its complexity and retreat to a simpler but less favorable result.

The fact that some taxpayers have "access" to the legislative process to have the tax laws changed to benefit their particular situations may also contribute to complexity, he says.

Professor Surrey also notes that complexity may result when the magnitude of a tax problem is not perceived because of the complex interrelation of rules. The simple problem later becomes one of larger scope than first imagined. For example, in 1946 the Congress expressed concern about the preferred stock dividend as a bailout of corporate earnings at capital gain rates. At that time, the solution (not adopted) appeared to be enactment of a short section denying tax-free treatment to certain preferred stock dividends. In 1954, when rewriting the Internal Revenue Code, the Congress realized that the preferred stock bailout was only one of a variety of bailout devices available to shareholders who desired to receive income at capital gain rates while retaining control of the corporation. The preferred stock bailout, the security bailout, the corporate division bailout, the partial liquidation bailout, and the liquidation and reincorporation bailout induced the Congress to write five Code sections, yet each continues to be treated as a discrete problem and not as an aspect of a single broad problem.

The remedy, Professor Surrey suggests, lies in continued and extensive research into the problems of tax structure.

John S. Nolan has said that the only solution for achieving broad-based tax reform and simplification is through a long-range plan under which a commission would be created to develop recommendations.[12] In general, there would be a schedule for consideration of major elements in the overall plan in stages over perhaps a 6-year period.

2. *The drafting of generalized or detailed tax statutes*

Professor Surrey notes that one of the chief criticisms of the Internal Revenue Code is the large number of extremely detailed provisions. A detailed statute has the advantage of providing answers to the questions which are covered by the details, and hence is probably more satisfactory to business and to tax practitioners because they need the answers. On the other hand, a detailed tax statute requires skilled drafting in order to avoid leaving questions unanswered or creating new questions; also, it is difficult to keep a detailed statute current.

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[11] Surrey, *supra* at 691.

[12] Nolan, *A New Tax Structure for the United States—Problems of Implementation and the Impact of the Political Process*, speech delivered March 30, 1977, as part of the University of Michigan Key Issues Lecture Series.

Professor Surrey believes that three factors necessitate detail—the pressure for tax equity, the demand for curbs on tax avoidance, and a complex society's need for precise answers. He suggests a gradual shift from a highly detailed to a more generalized tax statute coupled with a clear delegation to the Treasury to write regulations of whatever detail needed for such purposes. With a more general statute, problems of structure and policy should become more clearly visible to the legislators; and regulations lend themselves to improvement more readily than detailed statutory provisions.

However, Professor Surrey cautions that shifting to a more generalized tax statute would bring about new roles for the Congress, Treasury, the courts, drafters of legislation, and the tax profession. Treasury would have to rise above the partisan nature of administrative activities exercised in audit, settlement, and litigation, in order to develop expertise and background information necessary to formulate more detailed regulations. The Congress would have to permit the judgments of Treasury to stand in spite of pressure for change from unhappy constituents. The courts would have to recognize Treasury decisions as authoritative except in rare instances. The drafters of the statute would have to develop new techniques to establish basic principles and provide guidance to Treasury without becoming entangled in detail. The tax profession would have to accept the Treasury as the arbiter of tax detail, rather than resorting so often to the courts or legislature.

The New York State Bar Committee also recommends that future tax legislation be more generalized rather than detailed, and that the details be left to the Treasury to fill in through regulations and rulings. Essentially, the same recommendations have been made by Professor Eustice.

E. The Role of the Treasury in Tax Complexity

The New York State Bar Association Committee contends that the Treasury makes major contributions to the complexity of the tax law. The committee stated that excessive Treasury concern for revenue loss and tax abuse has led it to seek legislation which is too specific or which narrowly limits the number of taxpayers who might benefit from the easing of certain tax burdens. The committee recommends that Treasury hire more personnel and consult more with experienced tax lawyers.

The committee also recommends that Treasury use temporary regulations more often, and establish a policy of stating a position on all significant matters of interpretation at the earliest possible date.

To alleviate delays in the rulings process, the committee suggests setting a short deadline on issuing rulings, and if this could not be met, the Internal Revenue Service should issue interim rulings which would protect the taxpayer until the final ruling was published or the ruling was later revoked. The committee recommends a "small rulings" branch be established to give speedy service on rulings involving relatively small amounts of tax (less than $50,000) in nonrecurring situations. The Service should also decide more quickly whether it acquiesces in Tax Court cases.

Lack of uniformity and delay in audits are the Service's chief administrative problems, the committee states. Increased automation and a hearing procedure for those who feel they have received nonstandard treatment are suggested as solutions to these problems.

Professor Eustice likewise takes the position that the Treasury's concern with the loss of tax revenues contributes to complexity. He also notes that the occasional diversion of Internal Revenue Service manpower for nontax functions (e.g., the wage and price control program) reduces the Service's ability to deal with complex tax problems.

F. The Role of the Courts in Tax Complexity

Arguing that the chief cause of tax complexity in the judicial system is the lack of uniform review, and therefore lack of uniform results, many commentators have called for a separate tax court system with its own court of appeals. Thus Professor Surrey has stated: [13]

> It hardly seems efficient to have an elaborate Tax Court procedure alongside a District Court system and a Court of Claims forum as well; or to have Tax Court decisions spreading out for appellate review to eleven Courts of Appeals; or to have complex civil tax issues decided by juries; or to have so much turn on the deficiency as against the refund procedure.

The New York State Bar Association Committee also declares that the diversity of forums and the lack of uniform review results in complexity and delay in judicial resolution of tax matters. The committee recommends that the U.S. Tax Court have primary jurisdiction in civil tax matters, including refund suits involving income, estate, gift, or excise taxes, and that the U.S. District Courts should be simultaneously divested of such jurisdiction. The committee further recommends creation of one Tax Court of Appeals to handle all tax appeals now divided among the U.S. Courts of Appeals, thereby ending the situation in which the Tax Court may be forced to decide identical cases on the basis of different rules because the cases are to be appealed to different circuits.

Professor Eustice endorses the committee's recommendations for a "single track" court system from the Tax Court to a new Court of Tax Appeals, and the removal of jurisdiction over tax cases from the U.S. Court of Claims, District Courts, and Circuit Courts.

G. The Role of Tax Practitioners in Tax Complexity

Commentators have concluded that tax practitioners generally do little to aid the cause of tax simplification, and that practitioners have a professional responsibility to do more.

The New York State Bar Association Committee points out that the tax lawyer, when representing a client, may develop novel theories in litigation, seek legislative solutions to the client's problems, and advise the client on methods to avoid high tax rates. If successful, the lawyer may add significant complexity to the case law and administrative process.

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[13] Surrey, *supra* at 693.

The committee notes that lawyers can enlighten or confuse in their role as educators of the public. Lawyers, whether writing, educating on tax topics, advising the government, or acting in groups, should provide leadership, guidelines, advice, and criticism.

Further, the New York State Bar Association Committee recommends that tax practitioners work with other groups concerned with tax complexity. Members of Congress, judges, Internal Revenue Service officials, and tax practitioners should get together to examine broad principles, such as division of responsibilities between the Congress and Treasury, overhaul of the entire tax structure, and basic premises of tax theory.

H. Progress Toward Simplification

Discussing the Tax Reform Act of 1969, Dr. Woodworth notes that compliance burdens for low and middle income taxpayers have been reduced. Problems resulting from calculating and verifying itemized personal deductions have been alleviated for many taxpayers by increases in the standard deduction and the low-income allowance. Raising the amount of income necessary to trigger filing requirements has simplified the compliance burden for those taxpayers in poverty level income categories. To complement the higher filing requirements, low-income individuals who would not be subject to tax are allowed to eliminate withholding from their wages. Tax tables to eliminate individual calculations of the tax and computation of the tax by the Internal Revenue Service also make compliance easier for taxpayers.

To achieve further simplification, the New York State Bar Association Committee suggests restricting itemized personal deductions to those taxpayers with really extraordinary expenses. Thus, unless expenses exceeded 10 or 15 percent of adjusted gross income, there would be no deductions. This change would be combined with the elimination of the standard deduction (perhaps retaining the low income allowance) and using the resulting revenue to reduce tax rates. Lowered rates might further reduce complexity by limiting the tax maneuvering "that is inevitable with a 70-percent top rate."

The committee also suggests that certain Code sections either be made inapplicable to or simplified for low-income taxpayers. Thus, "the law might eliminate the complicated tiers of capital gain rates and capital loss carryovers, the multiple limitations on medical expenses, the minimum tax on preferences, sick pay and retirement income, net operating loss carryovers, depreciation recapture (Sections 1245 and 1250), collapsible corporations (section 341), investment credits, . . ." A broadly based study "employing this approach might produce a tax return comprehensible to less sophisticated taxpayers, and possibly a separate Code of substantive provisions written in language comprehensible to them."

Professor Surrey cites various administrative factors which tend to lessen the complexity of the income tax—graduated withholding at the source of wages and salaries; use of the standard deduction to obviate the problems involved with personal expense deductions; improvements in tax return forms and instructions; the use of automatic data processing of returns; and availability of the rulings procedure.

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