

Editor's Column
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Complexity of the Code

“[The federal government] should have a tax system which looks like someone designed it on purpose”

William E. Simon (former Treasury Secretary)

The [tax] code today encompasses 9,500 pages of very small print. While every word...has some justification, in its entirety it is an abomination”

Paul O'Neal (Treasury Secretary) in 2001

“It is time for a complete overhaul of our income tax system... it is a disgrace to the human race.”

Jimmy Carter in Accepting the Democratic Nomination in 1976

As a result of the 1996 Taxpayer Bill of Rights II, section 7803 of the Code provides: *“not later than December 31 of each calendar year, the National Taxpayer Advocate shall report to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate on the activities of the Office of the Taxpayer Advocate during the fiscal year ending during such calendar year. Any such report shall contain full and substantive analysis, in addition to statistical information, and shall ... contain a summary of at least 20 of the most serious problems encountered by taxpayers, including a description of the nature of such problems...”*

In this edition of the Journal we have attached the January 2009 report of IRS's National Taxpayer Advocate. In the January report, the Taxpayer Advocate states: *“The largest source of compliance burdens for taxpayers is the complexity of the tax code. IRS data show that taxpayers and businesses spend 7.6 billion hours a year complying with tax-filing requirements. To place this in context, it would require 3.8 million full-time employees...”*

Part of Code Section 509(a) reads: For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3).

The first annual report by the Taxpayer Advocate in 1997 called tax complexity *“the single most burdensome aspect of compliance for most taxpayers.”* It should be noted that a similar statement has been included in every one of the Advocate's annual reports for the last 11 years.

Among the elements noted by the January report:

- *“we estimate that taxpayers spend \$193 billion a year complying with income tax requirements, which amounts to 14 percent of aggregate income tax receipts”*
- *“... over the past eight years, changes to the tax code have been made at a rate of more than one a day – including more than 500 changes in 2008 alone”*

- “about 60 percent of individual taxpayers pay practitioners to prepare their returns and an additional 22 percent purchase tax software to assist them”
- “More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer’s income increases.”
- “The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today.”

The January report states: “The National Taxpayer Advocate recommends that Congress substantially simplify the tax code. To assist Congress in pursuing tax simplification, this report includes a series of recommendations, including recommendations to repeal the Alternative Minimum Tax, streamline education and retirement savings tax incentives, simplify the family status provisions of the Code, allow taxpayers to exclude modest amounts of canceled debts from income without having to make an affirmative claim, reduce tax sunset and phase-out provisions, and revise the overall penalty structure. (See next section summarizing Legislative Recommendations.) More broadly, the report recommends six principles on which fundamental tax reform should be based.”

The IRS reported that the average time to prepare form 1040 for the year 2007 was expected to be 33.5 hours – almost a week’s work for the average taxpayer.

The lack of Congressional honesty (by both parties) in adopting changes to the Code has often been absurd. For example:

- When Congress adopted Code section 2057 in 1998, it was intended to provide estate tax relief for closely held family businesses. Unfortunately, the Code section had over 20 separate variables which could result in disallowance of its benefits. The wording of many of these variables was ambiguous at best. For example, the value of the closely held business could not include: “cash or marketable securities, or both, in excess of the reasonably expected day-to-day working capital needs of such trade or business.” Unfortunately, this “excess cash” limit was never objectively defined, making it impossible for a client to know whether they qualified for the benefit. This lack of certainty in section 2057 substantially limited its use by practitioners.
- As note above, more than half of all taxpayers are losing tax benefits because of the phase-outs in the Code. Effectively, each phase-out acts as a disguised tax by raising taxpayers into rates higher than those reflected in Code section 1.
- When Congress adopted the Economic Growth and Tax Relief Reconciliation Act of 2001, it balanced the tax cuts by an explosion of taxpayers expected to begin paying Alternative Minimum Taxes.
- According to a 2005 report by RIA, taxpayers at adjusted gross income from \$75,000 to \$300,000 were more likely to pay Alternative Minimum Tax, than taxpayers above \$500,000. When middle income taxpayers are centrally targeted by AMT, something is seriously wrong with the Code.

Unfortunately, Washington does not seem to be listening to either taxpayers confounded by a complex tax code or the IRS’s Taxpayer Advocate. While blue ribbon panels continually call for simplification of the Code, political results are hard to come by. For example, in April 2001,

Congress issued a 1,292 page, 5 pound report on how to simplify the Federal Tax Code. The report has become a good book end, but provided little true impact on the Code.

The Income Tax Code Adopted in 1913 had 14 pages. According to the January 2009 report of the Taxpayer Advocate, the Code now contains over 3.7 million words.

We are on the cusp of a massive sun-setting of major provisions of the Code. By one estimate, from 2008 through 2010 over \$4.0 trillion in tax benefits will expire. Change is coming to the Code

– whether Congress adopts new legislation or gets caught up in partisan gridlock and the changes occur because of sun-setting tax provisions.

Other factors are also going to affect changes to the Code:

- According to the 2008 Social Security Trustees Report, in 2017 Social Security will start paying out more money than it takes in – ballooning the federal budget deficit.
- The cost of the economic stimulus and bail out plans will have to be paid by someone.
- The cost of two wars is not going to abate anytime soon.
- Federal health care costs will continue to rise as baby boomers and their parents age. Any version of universal health care will only increase this cost.
- Every new President wants to put his own agenda into the tax Code. With the Democrats now controlling Washington, they will have their own ideas of how to change the Code and reward their perceived constituents.

With \$4.0 trillion of sun-setting tax law, Washington will be talking about tax reform in 2009, but will it also be addressing tax simplification? The two are not the remotely the same. Tax reform is often about raising someone else's relative tax burden. Tax simplification is about building an understandable and fair system where you can know what to expect from the Code.

While the complexity of the Code certainly provides a living to many of us as tax practitioners, the Code's failure to have a rational basis undercuts the public's confidence in Washington and the perception of fairness that stands at the core of a voluntary system of taxation. It is beyond time for serious simplification of the Code. Hopefully, a new President and a New Congress will see tax simplification, and not just tax reform, as a major part of their 2009 agenda.

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