



AMERICAN BAR ASSOCIATION

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TESTIMONY

OF

RICHARD A. SHAW

ON BEHALF

OF THE

AMERICAN BAR ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS & MEANS

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Thank you, Mr. Chairman. My name is Richard A. Shaw. I am Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the American Bar Association.

The American Bar Association appreciates the opportunity to appear before the Subcommittee on Oversight (the “Subcommittee”) today to discuss the critical need for simplification of the federal tax laws. We know this is an issue the Subcommittee takes seriously, and we appreciate the efforts the Chairman and other Members of the Subcommittee have taken over the past few years to focus attention on the need for simplification.

ABA Section of Taxation

The ABA is comprised of more than 400,000 members and its Section of Taxation has approximately 20,000 tax lawyers who work in law firms, corporations and other business entities, government, nonprofit organizations, academia, accounting firms and other multidisciplinary organizations. Accordingly, to make the tax system fairer, simpler and easier to administer is one of the Association’s legislative priorities.

Our members provide advice on every substantive and procedural area of the tax laws, and interact regularly with the Internal Revenue Service (the “Service”), the Treasury Department, and other government agencies and offices responsible for administering and enforcing the tax laws. Many of our members have served in staff and executive-level positions at the Service, the Treasury Department, the Tax Division of the Department of Justice, and Congressional tax-writing committees.

The Need for Simplification

The ABA and its Section of Taxation have long been strong advocates for simplification of the Internal Revenue Code. For nearly thirty years, the ABA has been on record urging tax law simplicity, a broad tax base and lower tax rates.

We have reiterated this position in testimony before Congressional tax-writing committees on numerous occasions. For a number of years, the Section of Taxation has worked with our colleagues at the AICPA Tax Division and the Tax Executives Institute on this important issue. The Tax Section will continue these efforts and we remain optimistic that real steps can be taken by Congress to simplify the tax laws.

We believe that complexity is at the root of many significant obstacles to efficient and effective administration of the tax laws.

First, as the National Taxpayer Advocate and others have well documented, the scope and complexity of the tax laws make it virtually certain that taxpayers will face procedural, technical and bureaucratic obstacles in meeting their tax obligations. This not only creates problems on the front end, when taxpayers attempt to prepare and file returns, but also at the back end, when errors rooted in complexity result in audits and controversy with the Service.

Second, as the staff of the Joint Committee on Taxation documented in their comprehensive 2001 study on tax simplification, complexity has materially reduced taxpayers' perceptions of fairness of the federal tax system by creating disparate treatment of similarly situated taxpayers. Although perceptions – and their impact – are difficult to measure, it is hard to imagine how taxpayers or Congress can see the Service as an efficient, modern and responsive agency if they do not perceive the tax law itself to be fair.

Third, as we have seen in recent years, tax law complexity creates opportunities for technical manipulation of the tax laws – often in ways never contemplated by Congress. Aggressive exploitation of ambiguities in the laws not only further aggravates the perception problem, but also forces the Service to divert resources from working with compliant taxpayers in resolving legitimate issues of interpretation to pursuing the aggressively noncompliant instead.

Legislative Simplification

Of course, we recognize that simplifying the tax law requires Congress to make difficult choices. This is particularly true when, as now, the political realities of the fiscal balance limit the ability to simplify in a manner that reduces revenue. Simplification necessitates a willingness to embrace objective proposals that are often dull and without passionate political constituencies. Simplification also requires that politically popular proposals be avoided if they would add significant new complexity. Simplification – and preventing greater complexity – may not garner political capital or headlines, but it is crucial to a tax system that is fair and can be efficiently administered.

The Code is replete with tax provisions where the burden of complexity is much greater than the perceived abuse to which the provision was aimed, or the benefit that was deemed gained by its addition.

Frequently, taxpayers, or more likely their tax representatives, must engage in a torturous struggle through a maze of cross-references and inconsistent definitions to ascertain that a set of complex provisions are not relevant to a transaction or tax obligation.

The Code contains many provisions that at the time of enactment may have been desirable, but with the passage of time, or the enactment of other changes, have truly become “deadwood.” Despite the absence of any practical utility in such provisions (whether in a relative or absolute sense), analysis of the effect of such provisions will generally be required, either in the preparation of the tax return or in the consummation of a proposed transaction. The elimination of such provisions would greatly simplify the law.

In the past, working with our colleagues in the AICPA and TEI, examples of provisions have been offered that, when analyzed, do not justify their continuation in the law. We are grateful that the Congress has acted to address some of these problems. We encourage you to continue these efforts, as every step taken to simplify the tax laws is an important part of providing tax relief to the American taxpayers.

Today I want to draw your attention to a few areas in particular: the complexity wrought by the numerous provisions of the tax code that phase-out tax benefits based on income levels, and the complexity caused by the multiple definitions of a "child" under the tax code.

As you know, the tax code is often used to distribute benefits under a variety of social policy programs among selected groups of taxpayers. To accomplish these diverse goals, many code sections phase-out available deductions and credits over various income ranges based on differing measures of taxpayer income. Currently, these phase-out ranges are not consistent either in defining income, the applicable levels of income, the range of income over which the phase-out applies, or the method of applying the phase-outs. The phase-out ranges even differ depending on the filing status of the taxpayer, and these differences are also internally inconsistent. As a result, phase-outs cause inordinate complexity – particularly for taxpayers attempting to prepare their own returns without the assistance of tax preparation software.

The staff of the Joint Committee on Taxation recommended three years ago that most phase-outs be eliminated and in 2002, the ABA adopted a formal policy to support that position. Congress has already taken an initial step in this effort by providing that, beginning in 2006, two of these troubling phase-out provisions, dealing with personal exemptions and the overall limitation on itemized deductions, will begin to be eliminated. We applaud this legislative action, and encourage the Subcommittee to seek out ways of building on that experience to address further the problem of unduly complex phase-outs.

As the Subcommittee is undoubtedly aware, the use of different definitions to determine who is a qualifying child for purposes of:

- (1) the dependency exemption;
- (2) the earned income tax credit ("EITC");
- (3) the child credit;
- (4) the dependent care credit;
- (5) and head of household filing status,

has led to widespread confusion and inadvertent errors. Taxpayers mistakenly believe that if they have a "child" who qualifies for one of the benefits, they are entitled to all of them. These errors inevitably lead to controversies with the Service that are very difficult for taxpayers and particularly, lower-income families to handle.

To the extent that the Service is required to devote its limited resources to sorting through the controversies caused by five (5) different definitions of "child," the end result is that the Service is not able to focus attention on other taxpayers in need of assistance or in pursuing enforcement against tax evasion.

The problems wrought by these confusing definitions of a child are well-documented, and similar approaches to simplifying this part of the tax laws have been endorsed by both the Treasury Department and the staff of the Joint Committee on

Taxation, as well as several Members of this Subcommittee. We encourage the Subcommittee to take whatever steps it can to further these efforts this year. We note that the 2005 budget proposals contain nine (9) specific tax simplification items. We strongly recommend consideration of the many recommendations made in the 2001 Joint Committee on Taxation Staff Report.

Regulatory Simplification

We also want to touch on the need to encourage regulatory simplification within the Treasury Department and the Service.

We appreciate that the Treasury Department and the Service have stepped up their efforts in recent years to work towards simplification through the regulatory process. The ABA and the Section of Taxation are committed to work with Treasury and the Service to continue such efforts. We also commend the Service for steps taken since 1998 to streamline the administrative system and improve the way the Service interfaces with taxpayers. We applaud efforts underway to redesign the examination and appeals processes to make them work more efficiently for both taxpayers and the Service. However, more can be done in the regulatory and administrative areas. As we recently advised the IRS Oversight Board, a cornerstone of the IRS strategic plan for the next five years must be a meaningful effort to simplify the tax law itself and the Service's procedures for interacting with taxpayers.

The Service's efforts to refine its modernization program should consistently consider the necessity for quality and efficiency in dealing with taxpayers. The lack of efficiency is evidenced by the inability of the system to satisfy adequately the statutory and regulatory objectives of the Offers-in-Compromise program. Taxpayers should not be stranded in compliance limbo while offers take more than three years to be processed through Appeals.

Prompt issuance of guidance advances the goal of simplification by reducing ambiguity and uncertainty. This can take the form of formal Revenue Rulings and Revenue Procedures that provide clarity and simplify the administration of complex and ambiguous laws and regulations. Prompt public releases are essential to provide guidance on new tax legislation. There have been at least twenty (20) new tax acts within the past five years affecting more than 300 sections of the Code. In addition, a strong program to modernize forms and instructions that make them more readily understandable and manageable to the average taxpayer can advance procedural simplification.

There are success stories. Much litigation was eliminated when the Treasury adopted a "check-the-box" system for unincorporated associations to elect to be treated as either corporations or partnerships. Likewise, the Service adopted practical procedural guidelines for remedying defecting S elections without requiring taxpayers to file expensive requests for revenue ruling approval.

Additional training is essential so that auditors and appeals officers are better able to explain and apply complex tax laws in a fair, consistent and just manner. Taxpayers and the system are not served well by Service Center communicators who are correct on complex tax laws only about 70% of the time.

We have encouraged the Service to actively work with this Subcommittee and the other tax-writing committees to ensure that you are fully educated on how much complexity adversely impacts the ability of the Service to achieve its mission.

In summary, our primary message today is the need for Congress to devote its energy and resources to promote changes in the tax laws that will lead to greater simplification. It is difficult to expect taxpayers to have any confidence that taxes imposed under current laws are collected accurately, when even experienced tax return preparers consistently get different tax results on similar data because of the complexity of the tax laws. The integrity, fairness and equity of the tax system require a concerted effort to obtain simplification.

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The ABA Section of Taxation hopes that the foregoing observations and suggestions are helpful to the Subcommittee. The Tax Section would be pleased to meet with you to further discuss these views or any other matters. Thank you.