

AMERICAN BAR ASSOCIATION SECTION OF TAXATION

Statement of Policy Favoring Tax Simplicity, Stability, and Transparency

The American Bar Association Section of Taxation (the “Section”) has a long history of advocacy for simplicity, stability, and transparency in our tax laws. At the Section’s urging, the House of Delegates of the American Bar Association has adopted policies supporting these principles. Significant policies approved by the House of Delegates include the following:

- 1976 and 1985 policies advocating tax simplification through adoption of a comprehensive and stable income tax base and accompanying rate reductions;
- A 1974 policy advocating inflation indexing of tax brackets, exemptions, and caps;
- A 1999 policy advocating repeal of the personal exemption and itemized deduction phaseouts, including advocacy of explicit rate adjustments as a more transparent approach to the “stealth tax” rate adjustments created by phaseouts; and
- A 2004 policy advocating repeal of the individual alternative minimum tax.

Simplicity

Simplicity in income taxation requires an over-arching bias against delivery of rewards and punishments through the tax system. The core, preferred approach should be an income tax base focused on the measurement of economic income, with due regard for ease of compliance, ease of administration, economic efficiency, and similar treatment for similar taxpayers. Following this approach for individuals whose incomes are limited to wages and a modest amount of investment income would create, for most of them, an extremely simple income tax system. For business taxpayers, measuring net income and placing it in the appropriate taxable year would still be considerably complex, but policymakers should guard against the growth in complexity that comes from adding rewards and punishments for selected activities.

It is difficult to imagine a desirable public policy goal that could not be advanced through a tax incentive. In some cases, the tax system may deliver incentives more efficiently than alternative approaches. In virtually all cases, beneficiaries of an incentive will be pleased to have the benefit, even with the accompanying complexity. However, it is not enough for the legislative or executive branches to weigh the nontax policy benefits of any single tax proposal against the incremental tax complexity added by the single proposal. That kind of micro-balancing inevitably leads to a federal tax system that is, in total, overly complex and unworthy of public respect.

An added benefit of a broad tax base is that it helps avoid the need for high rates. Any tax system will include flaws – many of which are necessary compromises. With high tax rates, these flaws can create significant economic and behavioral distortions. With lower rates, economic choices will tend not to be made based on tax factors, even if the system includes practical compromises that would threaten to become loopholes or unfair traps at higher rates. As

the experience of the Tax Reform Act of 1986 teaches, tax rates can be significantly lowered if the tax base is broadened.

In the course of advocating tax simplification over the years, we sometimes encounter people who assume that the Section and its members must want the tax laws to be complex, as sort of a jobs program for ourselves. The truth is quite the opposite. The application of any form of tax law to today's complex, global economy will require assistance from professionals who deal with tax issues on a daily basis. Helping clients understand the tax consequences of their business plans, and helping clients avoid tax problems, is a very enjoyable occupation when the rules make sense and are fair. It is when the rules do not make sense, or are not fair, that the work becomes frustrating. Our work experiences thus reinforce our general policy views in support of a tax system that is simple, with a broad base and low rates.

A simple tax system with a broad base and low rates will reduce burdens on the vast majority of taxpayers and the Internal Revenue Service (the "Service"). Simplifying the tax filing process for most individuals could reduce the costs of recordkeeping and the need to hire professionals or procure software programs each year to prepare and file tax returns. It also would reduce the likelihood of errors or disputes with the Service regarding the accuracy of returns, thereby reducing burden on both taxpayers and the Service. A simple tax system with a broad base would also enable the Service to streamline filing requirements and compliance efforts for most individual taxpayers, thereby freeing up resources to provide guidance where needed and to focus its compliance efforts on areas where they can provide the greatest impact on dealing with the tax gap.

Stability

For many years, the Section and its members have viewed with alarm the pace and volume of tax law changes. Much of this activity is mandated by budget-driven sunsets and the need to consider what to do about them. Keeping the tax laws the same for five years would present some problems, but it would provide enormous simplification almost without regard to the state of the tax law at the starting point.

The frequency of proposed and actual changes to the tax laws has several significant impacts on the tax system. Taxpayers have difficulty keeping up with changes and making long-term plans that are not upset with each Congressional session. The Treasury Department and the Service have difficulty keeping pace as well. Every time a new proposal is made to change the tax laws – whether originated by the Administration or Congress – the focus of Treasury's Office of Tax Policy necessarily shifts to dealing with the legislative proposal and away from providing guidance on existing laws. When new proposals are enacted, or existing provisions are modified, the Service must immediately revise tax forms, draft new regulations, and update its computer systems to address the changes. The pace of change thus degrades the ability of government agencies to provide prompt and thoughtful guidance on laws that are already on the books.

We strongly advocate a policy bias against sunsets and other similar approaches that require instability in our tax laws. We also urge a bias against change in law – not an insurmountable

bias, of course, but one that requires powerful policy merit to overcome and argues strongly against temporary provisions that necessarily will result in additional changes.

Transparency

Transparency is closely related to issues of simplicity, use of tax incentives, and stability. We use the term “transparent” to describe tax laws that apply in a straightforward and predictable way. We accordingly have opposed measures that increase or decrease tax burdens in an indirect or hidden fashion. Examples of hidden tax effects include disguising rate increases as phaseouts, imposing the alternative minimum tax rather than directly addressing tax preferences, and allowing inflation to generate tax increases when rates, brackets, and other key factors are not indexed.

A rough test of transparency is whether a taxpayer can easily estimate the tax effect of an increase in his or her income. There was a time when this was an easy exercise, especially for a taxpayer in the top tax bracket – the answer was that you applied the marginal tax rate to the additional income. The existence of the alternative minimum tax and phaseouts means that this estimation process certainly cannot be performed in one’s head; and even if it can be performed with the help of tax software, there are many data inputs required.

Use of the tax system as a provider of incentives is the historical reason for much of today’s transparency problems. The alternative minimum tax was intended to be a brake on excessive incentive usage – “help yourself, but don’t take too much.” The proliferation of incentives for lower income and middle income individuals in turn led to a proliferation of income-based “targeting,” under which only certain income levels are eligible for education incentives, individual retirement accounts, energy conservation incentives, and so forth. These limitations have the effect of hidden marginal rate increases and destroy transparency. They also undermine the intended incentive effects, because a potential incentive user cannot easily determine whether he or she will be eligible for the incentive. Any advertising or other promotion of the incentive cannot be broad based and must be burdened with caveats on eligibility. As a simple example, what had previously been extensive and effective promotion of individual retirement accounts became almost invisible not long after IRAs became subject to income-based restrictions. Adding to the confusion is the fact that phaseout ranges are not consistent from incentive to incentive. We would urge policymakers to be very skeptical about targeted tax incentives. If providing the incentive to all taxpayers is not appropriate, one should question whether the policy merits of the incentive are truly strong enough to merit its inclusion in our tax system.

The so-called “PEP” and “Pease” phaseouts in sections 68 and 151(d)(3) of the Internal Revenue Code of 1986, as amended, do not even have the merit of targeting. They are acknowledged to be “stealth” tax rate increases. These provisions are scheduled to be completely repealed in 2010 (and the phaseouts themselves are being phased out from prior levels from 2006 to 2009), but under the sunset provisions applicable to this and other tax cuts enacted in 2001, they would return in 2011. We would urge that this repeal be permanent, with any revenue effects being adjusted through explicit rate adjustments or other more transparent tax policies.

A related consideration involves the enactment of multiple incentives addressing similar behavior. As detailed in the comprehensive study of tax complexity conducted by the staff of the

Joint Committee on Taxation in 2001, “taxpayers are confronted with a confusing array of choices with respect to Federal tax incentives for financing education.”¹ In our experience, the result can often be that taxpayers cannot select the best alternative for their particular situation, thereby minimizing the value that Congress intended to provide. The JCT Study also noted that the “Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex sets of rules” and may be reducing the number of employees covered by employer-provided plans, thereby putting even greater pressure on Social Security and personal savings to provide for retirement.² These are two just examples of how a proliferation of related incentives can, by adding to taxpayer confusion, discourage the very activities that the incentives were intended to encourage.

Conclusion

The Section urges the Congress and the Administration to strive for simplicity, stability, and transparency in our tax laws. These areas can be improved through attention to the following areas:

- Stop adding to complexity by adding new rewards and punishment mechanisms to the tax law.
- Reduce the frequency of tax legislation, and avoid sunset provisions that require constant re-legislation.
- Avoid phaseouts, minimum tax rules, and similar measures that obscure the practical effect of tax law on economic activity.
- Strive for low tax rates and a broad tax base.

¹ Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendation for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS-3-01) (April 2001) (hereinafter “JCT Study”), volume II, page 135.

² *Id.* at volume II, page 149.