John E. ("Buck") Chapoton

By Jasper L. Cummings, Jr. and Alan J.J. Swirski*

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Q What are the biggest differences you see in the tax policy environment in 2014 compared to when you started in the Reagan administration working on tax reform?

A When I joined Treasury in 1981 as Assistant Secretary, President Reagan had just been elected. There was a great hope that he would take strong steps to reinvigorate the lackluster economy. The stock markets were just floating along without any big changes for a decade or so, and there were serious concerns that America was falling behind its trading partners in economic growth and innovation. The tax code was not the mess it is today, but politicians and the public alike thought the tax system was unfair and had serious flaws. Tax shelters allowed investors to reduce their tax bills almost at will—the unfairness of tax shelters was a big factor in the public's mind—but, most important, tax rates were far too high. The top individual tax rate was 70% in 1980. So there was lots of support for doing something to spur the economy forward, and most assumed that "fixing" the tax system would be essential to that effort. There was widespread hope that Reagan might be the man who could do it.

The supply siders and their mantra of lower tax rates had caught the ear of the new President early in his campaign, and this had appeal on Main Street and in Washington, on both sides of the aisle. A coalition of "Reagan Democrats," supporting the President and pushing for lower tax rates, organized in the House. This group, composed mainly of conservative, so-called "Blue Dog" Democrats, was key to the President's success in the Democrat-controlled House.

Thus, major tax cuts were the principal ingredient of the Administration's first economic package in 1981. The tax proposals passed Congress almost intact; many of the Congressional changes enhanced rather than diminished the benefits provided taxpayers (indexing of tax rates and the personal exemptions, for example). For individuals this Act meant a 25% cut in tax rates at every income level ("across the board") over a three-year phase-in, and for businesses it granted gigantic tax incentives for new investment in plant and equipment located in the U.S. (reinstatement of the investment tax credit and a new, much accelerated, depreciation schedule). Howard Baker, the new Senate majority leader, called the 1981 tax bill a "riverboat gamble," but the country and the Congress wanted to give this new President and his new ideas a chance to see if they might work to reinvigorate the economy. ERTA was passed rather resoundingly in both houses.

Q In addition to ERTA in 1981, Reagan signed major tax legislation in 1982, 1984, and 1986. What do you think accounts for those successes?

A ERTA, the 1981 bill, was the President's first tax victory and it was a very major piece of tax legislation. But it was by no means his last big tax victory in Congress. Reagan had many problems that later confounded his presidency, but his legislative magic on the tax side seemed to stay with him. His administration produced major tax bills in 1982 (TEFRA), 1984 (DEFRA), and finally fundamental tax reform in 1986. It's helpful to look more closely at the subsequent tax bills, particularly 1986 of course.

TEFRA in 1982 was a large tax bill but, in my view, it was basically corrective legislation, a reduction of the very generous cost recovery allowance passed in the euphoria of 1981, plus some very significant loophole closers of the old school. ERTA did almost nothing to tighten the tax code. The office of tax policy had—and I think always has—a list of "corrections" to the Code it would like to make given the legislative license to do so, but 1981 did not present that opportunity; 1982 did. After the major tax cuts in 1981, the deficit had suddenly become a major concern in the national economic debate, and many in the Administration sought ways to reduce the red ink. Interestingly, unlike today, revenue increases were acceptable to the Reagan White House so long as they could be classified as preventing tax avoidance or scaling back excessive tax benefits. That was a significant part of the 1982 legislation.

DEFRA, the 1984 tax bill, basically followed the example of the 1982 Act, tightening of the system to increase revenues without raising tax rates.

The final significant tax bill of the Reagan years was of course the monumental Tax Reform Act of 1986, and it was an entirely different animal. The 1986 legislation was a conceptual turn-around by the Reagan Administration. The 1981 Act, the Administration's opening salvo, was entirely a tax cut bill—reducing taxes by lowering rates and increasing tax deductions. In addition, a major conceptual goal of ERTA was to reduce

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the tax on capital, accomplished through lower taxes on capital gains for investors, and higher depreciation deductions and investment tax credits for businesses. Note that on the corporate side this benefitted only capital intensive businesses. Other businesses, such as the large service sector in this country, received no tax benefit in 1981; the corporate tax rate remained at a high 46%. The fundamental tax reform effort of the 1986 Act had a different goal—to broaden the tax base as much as possible by reducing or eliminating tax preferences built up over the years for both individuals and corporations, and to use the revenue raised by base broadening to lower all tax rates as much as possible. The goal of the 1986 effort was to be revenue neutral as compared to prior law, and to eliminate as much as possible government influence through the tax code. The mantra this time was, basically, "take tax considerations out of investment and business decisions and let the free market work." The effect was necessarily an increase in tax on capital—the exact opposite of the 1981 legislation. This was proposed and accomplished quite openly by eliminating tax preferences designed to encourage capital formation in the business sector—the investment tax credit and accelerated depreciation—and increasing taxes on capital gains of individuals. In return, tax rates were dramatically lowered for all individuals and all corporations. The objective was to reduce the drag and influence the tax system has on the U.S. economy as much as possible. Although hardly perfect, the Tax Reform Act moved the needle a very long way toward achieving that goal. Most tax policy observers would, I think, agree with that statement.

In cold political jargon this meant the individual tax cuts were "paid for" (in revenue terms) by taking away the accelerated depreciation and the investment tax credit benefits that had been adopted in 1981, Reagan's first tax bill. So the 1986 Act was a large increase in tax on capital generally (and businesses and investors specifically) and a reduction of tax on earnings of individuals and non-capital intensive businesses. Perhaps most surprising, the corporate community gave nary a peep of protest—many said this was a classic example of the support lower tax rates can buy. That's a political lesson the tax reform advocates of today should note.

Q Can you describe what you have been doing in the tax world since your work in the Reagan administration?

A After Treasury I returned to my law firm, Vinson & Elkins, as managing partner of the Washington office. During the late 1990s I became active in the Tax Section, primarily on the corporate tax shelter problem, and subsequently served as Vice-Chair of the Section for Government Relations. I retired from V&E in 2001 and opened the Washington office for Brown Advisory, a Baltimore-based investment advisory firm, where I still work. I remain interested and involved in the world of tax policy in a number of ways, including serving on the board of the Concord Coalition, a non-partisan think tank that addresses broad budget issues.

Q When you look at how tax policy and tax legislation was developed in the 1980s and compare it to today, what changes if any do you see from then to now?

A Of course the big change that everyone would point to, including me, is the political polarization in the Congress, and in the nation, that we witness today. The parties are just not working together, and even within parties there are major disagreements on basic questions of tax policy and, thus, little consensus how the tax code should be written. Achieving agreement on politically-charged tax issues was not a cakewalk in the 1980s, but compromise was not a bad word, as it seems to be now, and helpful legislation could be agreed upon then. The 1986 Tax Reform Act is the confirmation of that statement.

I remember one political disagreement in the early 1980s that might be an instructive example. In 1981 when Bob Dole was the new chairman of the Senate Finance Committee, he started holding Republican-only caucuses of the Senate Finance Committee members; they would meet separately, agree on resolutions of issues to be presented in an upcoming Committee markup, and since they represented a majority of the Committee, these decisions would sail through the formal Committee markup session. Well, you can imagine how that irritated the Democrats who were pretty much left out of the debate process. They complained, and Dole answered, and a compromise was reached. Today, the Finance Committee probably works together better than any other committee in Congress, but it's still not like it was. Members did talk to each other and while politics played a role, their motives were in major part to make the tax system better and more fair. Today the overriding question seems to be, not the substance, but how will this sell in my next election? That is not a formula for making good tax policy. I hope I'm overstating this problem, but I fear I'm not.

Q Is there one legislative change you would like to take back if you could?

A When I think about things that we did not do, I think about things that we did not do to make the system tighter and better. One that really jumps out at me is the international side, how U.S. companies should be taxed on activities abroad. We see companies that are basically U.S. entities for all substantive non-tax purposes and yet by formalistic structuring they are not treated as a U.S. entity for tax purposes. We also see individuals and corporations that are based in the U.S. avoiding our taxes by moving income-producing intangible assets to low-tax jurisdictions abroad. It is relatively easy to move intangible assets around the globe, and businesses make the case that large amounts of income follow those intangible assets, resulting in much lower taxes. I think we should have paid more attention to those issues that were just appearing on

the horizon, and I think the tax policy office should do so now. As I saw the tax law develop over the years, the courts and the Service said substance would prevail over form. We should find ways to reinvigorate that principle.

Q Was indexing for inflation a good or bad idea looking back at it from 30+ years in hindsight?

A That is a good question, and one which for some reason I am never asked. I was very suspicious of indexing when it was enacted. The Treasury had not proposed that change; it was pushed on us by the Senate Finance Committee. We accepted it and acted like we liked it, and I guess we did, although I'm not sure we analyzed its impact as thoroughly as we did other significant tax policy issues. But it's academic now; it's not going to be reversed.

Q What advice would you give policy makers who today are genuinely interested in tax reform?

A It seems to me what is missing in the effort is effective education of just how much damage the tax system does to the economy today because of unnecessary complexity and inefficiency. Tax reform is a frightening subject to most people. Our leaders have to explain that reform is possible without hurting most taxpayers—what they might lose in repeal of popular deductions and exclusions will generally be more than offset by tax rate reductions—and even when that's not the case, the benefits to the economy are more than worth it for themselves and the overwhelming majority of taxpayers. But it's not an easy task; the explanations have to be repeated often and in terms people can understand. Which brings me to the crucial ingredient—a committed President. In my view tax reform will not be possible without the effort of a President who is persuaded of its crucial importance, and his or her effective use of the bully pulpit. We don't have that now I'm afraid, although there are some groups who are making pretty persuasive arguments for reform.

Q Some blame the loss of moderates for the logjam on the Hill; some say that this is why there are fewer grand bargains. Do you believe that?

A I think that is a significant factor. Loss of moderates just means a higher percentage of polarized members. Members from polarized districts have little incentive to compromise. Gerrymandering has really made it difficult to elect people who are motivated enough to support a change that is best for the country even though some compromise is required, as it so often is in a democracy. Stated differently, districts that are "safe" for one party or the other do not strengthen our democratic system in my view.

Q Do you think the U.S. will ever adopt a VAT?

A I doubt the U.S. will ever adopt a value added tax. I think it will be discussed forever, but any kind of new tax system will be terribly frightening to the left and the right, conservatives and moderates, and that will pretty well kill it. The most recent example is the Simpson Bowles Commission. They considered a VAT at some length and decided they just were not going to recommend a new tax system for this country. I suspect they decided a VAT would present new policy considerations and have new good points and bad points like any tax system new or old, and thus new debates on old conceptual issues would start all over again. Although I see benefits from a VAT, I have concluded such an effort would set the tax improvement effort back, not advance it.

Q What do you think of the complexity of the Code today?

A The complexity of the present Internal Revenue Code is basically outrageous. The Code could be dramatically simplified, but to do it right would require a major undertaking and probably could be accomplished only as a part of fundamental tax reform. That doesn't mean more targeted simplification efforts shouldn't be attempted in every tax bill and in every legislative proposal Treasury sends to Congress. But I'm not hopeful.

I would like to mention one aspect of simplification I think should be discussed more. Over the years the tax bar and others have participated in the reorientation of our tax system from a system of principles to a system of rules. If the system relies only on rules, you'll get more and more detailed rules to shut down this loophole or that, but with enough work almost any rule can be avoided or circumvented. And of more concern, many taxpayers have to understand these complex rules even though they are not trying to skate close to the line. Detailed rules add immeasurably to the complexity of our system. In prior days, we had a much more principle-based tax structure. It is harder to avoid a principle. Sometimes principles are vague but so be it; this would not present a problem for the great majority of taxpayers who are not trying to manipulate a transaction to get the most tax juice possible out of it. But if Taxpayer A wishes to go closer to the line, he will want to have a good lawyer, or good accountant, to tell him whether he has crossed the line or veered too close to it. That's a good thing; Taxpayer A would be motivated to hire the best lawyer or the best accountant who is going to attempt to accomplish his motive and to protect him at the same time. Ours is a self-assessment tax system and that means professional tax advisors play a major role in the administration of our tax law. We want the best and most ethical carrying that role. Under the current system a taxpayer is often motivated to hire the least principled advisors, "I want the lawyer or accountant who will tell me what I want and give me an opinion that it will work." That will not build a tax system we will like. I should add that I realize I'm vastly oversimplifying a very complicated subject with this short answer. ■

Automatic Penalties for Failure to Timely File Forms 5471 or 5472

When a corporation files an untimely Form 5471 or Form 5472, Internal Revenue Service Center computers automatically assess a $10,000 penalty per form. The Service also automatically assesses the penalty on untimely Forms 5471 that are attached to late-filed partnership returns. Taxpayers have been told the Service plans to roll out the automated penalty procedures to other types of taxpayers (*e.g.*, individuals), but so far it has limited these procedures to corporations and partnerships. Additional penalties for insufficient information may be assessed on examination.

The Service will abate the automatic penalties under certain circumstances. For instance, if a taxpayer establishes reasonable cause for its failure to timely file, the Service must abate the penalty. The term "reasonable cause" is not defined in the Code or in the regulations applicable to Form 5471 penalties. Reasonable cause generally means that a taxpayer exercised ordinary business care and prudence but nevertheless failed to comply with its tax obligations.

The regulations applicable to Form 5472 penalties contain some guidance on the reasonable cause standard. Specifically, the regulations provide that reasonable cause may include an honest misunderstanding of fact or law that is reasonable considering the taxpayer's knowledge and experience. The regulations further state that "[r]eliance on an information return, professional advice or other facts… constitutes reasonable cause and good faith, if under all the circumstances, the reliance was reasonable." For example, a corporation may establish reasonable cause for failure to timely file Form 5472 if the corporation lacked knowledge and reason to know that it was owned by a 25% foreign shareholder and its belief was consistent with other information reported, furnished, or known to the corporation.

Additionally, taxpayers may qualify for automatic penalty relief associated with the 2012 Offshore Voluntary Disclosure Program (2012 OVDP). As applicable here, Frequently Asked Question 18 (FAQ 18) of the 2012 OVDP states that the Service will not impose a penalty for the failure to timely file international information returns (e.g., Form 5471 and Form 5472) if the taxpayer has no underreported tax liabilities from related transactions and the Service has not already requested the delinquent forms. FAQ 18 advises taxpayers to submit delinquent Forms 5471 or Forms 5472 on an amended return together with a statement explaining why the forms are late. Reasonable cause is not required. The Service now says FAQ 18 relief is not available to taxpayers under examination, but taxpayers are pushing back on that assertion.

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In my experience, the Service is less inclined to grant penalty relief under FAQ 18 when a taxpayer files a delinquent Form 5471 or Form 5472 with an original return rather than with an amended return. This counterintuitive tendency springs from the implication in FAQ 18 that the taxpayer files the delinquent Form 5471 or Form 5472 after filing the original return for the period. But FAQ 18 does not condition penalty relief upon a taxpayer filing a timely original return. In any event, the Service may amend or end the 2012 OVDP at any time, with or without prior notice.

A final alternative for penalty relief rests on guidance provided in the *Internal Revenue Manual*. When a taxpayer files a late Form 5471 or Form 5472 with a late-filed Form 1120, *U.S. Corporation Income Tax Return*, the *Manual* instructs Service employees to abate the Form 5471 or Form 5472 penalties when the following two conditions are met:

1. No penalty was assessed on the related Form 1120 (i.e., the Form 1120 reported no tax or the tax was paid timely) or the Service abated penalties on the late-filed Form 1120 under the First Time Abate program; and
2. The Service has not assessed penalties on Form 5471 or Form 5472, as applicable, in the preceding three years.

Conclusion

Although the Service may assess substantial penalties for failure to timely file international information returns like Forms 5471 and 5472, the Code, 2012 OVDP, and *Manual* set forth numerous grounds upon which the penalties may be abated. Taxpayers failing to meet the requirements for penalty relief outlined above may nevertheless find success in IRS Appeals. ■