

Who Will Champion Tax Reform?

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While it is unclear whether President Bush or presidential candidate Sen. John F. Kerry, D-Mass., will prove to be a true tax reform champion, observers say that whoever wins on November 2 will inherit a tax code that has devolved from cluttered to chaotic in the last two decades.

The Bush and Kerry campaigns have been largely silent on tax reform and simplification. The last planned effort at trimming the burgeoning tax laws happened 18 years ago when then-President Ronald Reagan and the Democratic-controlled Congress produced the Tax Reform Act of 1986 (P.L. 99-514).

Tax observers from across the political spectrum told Tax Analysts that although they've grown accustomed to watching the tax rules expand under each new Congress, the many temporary tax changes enacted during the Bush administration have compounded the complexity of the code. Republican lawmakers have handed Bush five major tax bills with brief shelf-lives during the last four years, advancing everything from decade-long marginal rate reductions (P.L. 107-16) to a 12-month repatriation proposal for global manufacturers (H.R. 4520; P.L. 108-357).

Tax Policy Center codirector William G. Gale said Bush's revenue-reducing has made uncertainty a hallmark of the code, arguing, "You can't look at the system from four years ago and say it's simpler, it's broader based, [or has] more consistent rates. They've definitely lowered the bar on what is acceptable behavior in that regard."

House Ways and Means Committee Chair William M. Thomas, R-Calif., however, characterized the increased complexity as a necessary evil in the battle to tighten the tax code of tomorrow.

"Changes that . . . may be seen as modest complication now . . . will aid us in making more fundamental simplification," Thomas assured reporters this past summer.

Bush recently proposed launching a new reform commission sometime in 2005 (see *Tax Notes*, Sept. 13, 2004, p. 1187). Kerry has promised to act on many international tax changes and anti-tax-avoidance measures, many of which became law when Bush signed the American Jobs Creation Act (P.L. 108-357) on October 22.

But at least one Washington tax lobbyist noted that new complexity traps like the manufacturing deduction, which is at the heart of the latest tax bill, would only damage the tax system further.

"What's the main obstacle to simplification reform? The president signing this bill," the lobbyist said.

For Sale: House of Cards

Mark W. Weinberger, a former Treasury assistant secretary for tax policy and now a vice chair for tax services at Ernst & Young, said the inherent problem facing simplification is that each new tax bill adds to the code, one constituency at a time.

"When Congress passes the law, obviously they look at a particular law in isolation and try and reach an objective," Weinberger said, adding that "someone who has to work through all the rules has to compare all these different tax laws that were enacted for several different purposes and put them together and come up with an answer."

Pamela F. Olson, former Treasury official and now partner at Skadden, Arps, Slate, Meagher & Flom LLP, Washington, attributed the manic tax-writing of the past four years in part to legislators' desire to proceed in the shortest amount of time possible. Olson said Bush and his economic advisers agreed to roll their myriad tax plans into the budget reconciliation rules "because it was seen as the best way to get something done that needed to be done quickly."

Now that the economy has started to stabilize, Olson predicted Bush would back away from the stop-and-start policies and push for more concrete tax goals.

"Unless there are more economic emergencies that have to be grappled with in a very short period . . . I don't know what the impetus would be to move it that way," Olson said. "At some point the president wants to see permanent changes made."

Chris Edwards, director of tax policy at the Cato Institute in Washington, said the self-imposed restraints Congress approved in the Graham-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985 and the "pay as you go" safeguards set the stage for the GOP's current sunset-intensive tax strategy.

"I think that one of the causes of complexity . . . is the large deficits and the intense focus on scoring," Edwards said. He suggested that before the enactment of the comprehensive fiduciary restrictions lawmakers "could focus more on good tax policy." Weinberger agreed, saying that if Kerry wins the election and resurrects the pay-go provisions, budget rules would continue to dictate the shape of the tax code.

While no fan of the budgetary constructs, Tax Foundation senior economist Scott Moody said fundamental reform would not necessarily eliminate the volatility in the tax laws because lawmakers could still play with the provisions from year to year to accommodate their fiscal or political needs.

Instead, he urged tax policy specialists to focus their attention on the real problem: nailing down a uniform definition of income.

"We have not seriously tackled the definition of income. And until we do, through some fundamental tax reform, tax complexity is going to be with us in a very big way," Moody told Tax Analysts.

Willbanks said taxpayers shoulder some of the blame for complexity 'by saying, "OK, if you're going to tax this transaction in that particular way, then I'll change the form of the transaction."

Stephanie J. Willbanks, a Vermont Law School tax professor, blamed the sophistication of the U.S. economy and the growing number of financial instruments for fueling the complexity boom. "I think we the people have a responsibility here for the complexity, because we keep trying to outdo the code by saying, 'OK, if you're going to tax this transaction in that particular way, then I'll change the form of the transaction.'"

National Taxpayers Union consultant David Keating agreed, condemning the convenience of computerized tax preparation for silently contributing to the corruption of the code. "If people actually had to calculate this stuff with pen and paper like they used to not all that long ago, people probably wouldn't be able to do anything other than sit around and calculate their taxes," Keating noted. "So it could be that computers are just encouraging Congress to get more complicated."

Keating said a divided Congress or an independent White House often breeds convoluted taxwriting because bipartisanship mandates "provisions being put in to meet political differences and a revenue target to boot." Gale dismissed Keating's dour political assessment, noting that the 1986 reform act was passed during a deficit crunch and while the White House was under the control "of an avowed tax cutter."

"There's nothing in the fact that [Congress is evenly divided] . . . that suggests that compromises can't be reached," Gale said.

But Sheldon Cohen, a former IRS commissioner and now a partner at Morgan, Lewis & Bockius LLP, Washington, said times have changed for the worse. He chastised everyone from the current Treasury officials on down to the taxwriters themselves for sitting idly by while the tax system continues to worsen.

(Text continued on p. 644.)

This table presents a sampling of complex individual and corporate tax provisions that have been routinely amended in recent years.					
Code sections	1985-1988 <i>President: Ronald Reagan (second term)</i> <i>House: Democrats control</i> <i>Senate: Republicans control until 1988</i>	1989-1992 <i>President: George H. W. Bush</i> <i>House: Democrats control</i> <i>Senate: Democrats control</i>	1993-1996 <i>President: Bill Clinton</i> <i>House: Democrats control 1993 & 1994, then Republicans control</i> <i>Senate: Democrats control until 1994</i>	1997-2000 <i>President: Bill Clinton (second term)</i> <i>House: Republicans control</i> <i>Senate: Republicans control</i>	2001-2004 <i>President: George W. Bush</i> <i>House: Republicans control</i> <i>Senate: Republicans control from January 2001 to June 2001, Democrats control again for the rest of 2001 until 2003, Republicans currently control</i>
Alternative Minimum Tax — section 55 <i>Description:</i> Computes alternative minimum tax liability as the excess of tentative minimum tax over regular tax liability. For non-corporate taxpayers, the tentative minimum tax is 26 percent of the first \$175,000 of alternative minimum taxable income (AMTI) in excess of the applicable exemption plus 28 percent of any additional AMTI. For corporate taxpayers, the tentative minimum tax for the tax year is 20 percent of the excess of AMTI over the \$40,000 AMTI exemption amount, reduced by the AMT foreign tax credit. First Enacted: 1978; 1969 "add-on" minimum tax repealed 1982	5 amendments, including: • 1 in 1986 • 4 in 1988	4 amendments, including: • 2 in 1990 • 2 in 1992	9 amendments, including: • 4 in 1993 • 5 in 1996	7 amendments, including: • 5 in 1997 • 2 in 1998	13 amendments, including: • 4 in 2001 • 5 in 2003 • 4 in 2004
Earned Income Tax Credit — section 32 <i>Description:</i> A special credit for low-income workers that reduces the amount of tax owed, if any, and is fully refundable even if the worker owes no tax. First enacted: Mar. 29, 1975	7 amendments, including: • 5 in 1986 • 2 in 1988	7 amendments in 1990	16 amendments, including: • 6 in 1993 • 1 in 1995 • 9 in 1996	18 amendments, including: • 17 in 1997 • 1 in 1999	23 amendments, including: • 15 in 2001 • 1 in 2002 • 7 in 2004

<p>Maximum Tax on Capital Gains — section 1(h)</p> <p><i>Description:</i> The tax on long-term capital gains is limited to specific rates. Since 1997, this rate has varied depending on the kind of gain. Kind of gain is determined by classifying gain into collectables gain, section 1250 unrecaptured gain, and other long-term capital gain. This approach had a long history before the 1986 act eliminated a preference for long-term capital gain. The 1990 act restored a new tax rate limitation.</p> <p>First enacted: 1990</p>	Not in statute	1 amendment in 1990	2 amendments, both in 1999	3 amendments, including: <ul style="list-style-type: none"> • 1 in 1997 • 2 in 1998 	3 amendments, including: <ul style="list-style-type: none"> • 1 in 2002 • 2 in 2003
<p>Pensions — section 401(k)</p> <p><i>Description:</i> A profit-sharing or stock bonus plan qualifies under section 401 even if the employee may elect to either have the benefits paid to a trust under the plan or directly to the employee as cash.</p> <p>First enacted: 1981</p>	14 amendments, all in 1986	No amendments	9 amendments, all in 1996	5 amendments, all in 1997	No amendments
<p>Tuition Program — section 529</p> <p><i>Description:</i> Enables a person to buy tuition credits or certificates or make contributions to an account to pay the qualified higher education expenses of a designated beneficiary. A qualified tuition program itself is exempt from income tax, but is subject to the tax on unrelated business income under section 511.</p> <p>First enacted: Aug. 20, 1996</p>	Not in statute	Not in statute	2 amendments, both in 1996	16 amendments, including: <ul style="list-style-type: none"> • 12 in 1997 • 2 in 1998 • 2 in 2000 	17 amendments, including: <ul style="list-style-type: none"> • 13 in 2001 • 1 in 2002 • 3 in 2004
<p>Partner's Distributive Share — section 704</p> <p><i>Description:</i> How partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership is determined.</p> <p>First enacted: Aug. 16, 1954</p>	No amendments	2 amendments, including: <ul style="list-style-type: none"> • 1 in 1989 • 1 in 1992 	No amendments	1 amendment, in 1997	1 amendments in 2004
<p>Interest — section 163</p> <p><i>Description:</i> Provides rules outlining when interest paid or incurred in a tax year on indebtedness is deductible.</p> <p>First enacted: 1913</p>	26 amendments, including: <ul style="list-style-type: none"> • 8 in 1986 • 3 in 1987 • 15 in 1988 	10 amendments, including: <ul style="list-style-type: none"> • 5 in 1989 • 5 in 1990 	7 amendments, including: <ul style="list-style-type: none"> • 5 in 1993 • 2 in 1996 	11 amendments, including: <ul style="list-style-type: none"> • 8 in 1997 • 2 in 1998 • 1 in 1999 	2 amendments, both in 2003

<p>Limitation on Foreign Tax Credit — section 904</p> <p><i>Description:</i> Limits the foreign tax credit allowed under section 901(a).</p> <p>First enacted: Before 1954</p>	<p>40 amendments, including:</p> <ul style="list-style-type: none"> • 21 in 1986 • 19 in 1988 	<p>5 amendments, including:</p> <ul style="list-style-type: none"> • 2 in 1989 • 3 in 1990 	<p>6 amendments, including:</p> <ul style="list-style-type: none"> • 2 in 1993 • 4 in 1996 	<p>9 amendments, including:</p> <ul style="list-style-type: none"> • 8 in 1997 • 1 in 1999 	<p>11 amendments, including:</p> <ul style="list-style-type: none"> • 7 in 2001 • 2 in 2002 • 2 in 2004
<p>Limitations on NOL Carryforwards — section 382</p> <p><i>Description:</i> Imposes limitations on the use of pre-ownership-change tax losses of purchased corporations (loss corporations). The limitation for any post-ownership-change year is an amount equal to the value of the old loss corporation multiplied by the long-term tax-exempt rate.</p> <p>First enacted: Aug. 16, 1954</p>	<p>36 amendments, including:</p> <ul style="list-style-type: none"> • 2 in 1986 • 2 in 1987 • 32 in 1988 	<p>8 amendments, all in 1989</p>	<p>2 amendments, including:</p> <ul style="list-style-type: none"> • 1 in 1993 • 1 in 1996 	<p>No amendments</p>	<p>No amendments</p>
<p>Uniform Capitalization Rules — section 263A</p> <p><i>Description:</i> The direct costs and part of the indirect costs for production or resale activities must be capitalized. Those costs are included in the basis of property produced or acquired for resale, rather than claimed as a current deduction. The costs are recovered through depreciation, amortization, or cost of goods sold when the property is used, sold, or otherwise disposed of.</p> <p>First enacted: Oct. 22, 1986</p>	<p>12 amendments in 1988</p>	<p>1 amendment, in 1989</p>	<p>2 amendments, both in 1999</p>	<p>No amendments</p>	<p>No amendments</p>

"I just think these people really don't care. They're saying the right things politically and they will do whatever they can do to get what they need . . . and then they worry about the rest of it later," Cohen said. "We don't have any crusaders out there."

Etch-a-Sketch Politics

According to Willbanks, the cyclical nature of Congress means temporary tax provisions are far from uncommon in Washington. But she expressed concern that the numerous transitory stimulus measures and economic incentives that have crept into the code with Bush's blessing would become the rule rather than the exception.

"It seems to me . . . that we have accelerated the pace of changing the code," she said, labeling the 2001 tax bill a watershed act that may redefine taxwriting in the modern era.

And that Willbanks said while using phase-ins for budgetary reasons is a familiar practice, the current estate tax repeal setup has made things unclear for estate planners and law professors alike — while ensuring that annual estate-drafting sessions will continue through 2010. She noted that although the estate tax repeal is no longer a top priority, most practitioners believe a more permanent solution will likely hinge on the outcome of the election.

"And so we've all been waiting for that other shoe to fall," she said. "But we don't know if it's the right or the left shoe."

Weinberger denounced the rise of temporary tax cuts, but attempted to distinguish between laws that are hard to understand (true complexity) and time-sensitive tax changes (inconvenient), classifying the various phase-ins and phaseouts enacted under the Bush administration as more of a planning hurdle than a complexity burden.

Keating says those hurdles may hamper the tax reform efforts of the very same Republicans who dropped them into the code. Keating cited the increasing number of taxpayers who are dropping off the tax rolls — thanks to provisions such as the child credit expansion — as a self-imposed impediment to any serious GOP reformers. "I guess they just have a smaller tax base to work with; they're just more hemmed in," Keating said of the pending political conundrum.

Edwards was equally skeptical, estimating that it would be difficult for GOP taxwriters to rail against a code that has been largely redefined by a decade of Republican control. "It's going to be so hard for Republicans to repeal some of the things they've put in the tax code themselves . . . [so] I think they have to start thinking a little differently."

But Olson said she believes tax reformers have plenty of opportunity, particularly if they latch on

to the simplification proposals the Bush White House has included throughout its annual budget recommendations. Some of their policy objectives include:

- streamlining personal savings provisions by replacing employer-based savings accounts with new lifetime savings accounts, retirement savings accounts, and employer retirement savings accounts;
- reforming the excise tax treatment of investment income by private foundations;
- eliminating the household maintenance test for head-of-household filing status;
- reducing the computational complexity of the refundable child tax credit;
- simplifying the earned income tax credit eligibility rules;
- simplifying dependency exemptions;
- consolidating the rules for the lifetime learning credit, HOPE scholarship credit, and education expense deductions and simplifying other higher education provisions;
- allowing annual reporting and payment of combined state and federal unemployment insurance taxes by employers of household employees; and
- simplifying taxation of capital gains on collectibles, small-business stock, and other assets.

Currently, Congress has enacted only one of Bush's simplification initiatives — the uniform child definition finally passed as part of the Working Families Tax Relief Act of 2004 (P.L. 108-311) — a poor track record that gives Olson little hope for an overnight reform rush.

'Unfortunately simplification doesn't have a lot of sizzle' as a political issue, said Olson.

"It is difficult to put out a full-blown set of simplification proposals unless you've got some folks on the Hill expressing an interest in moving them," she said of the hazy reform outlook. "Unfortunately simplification doesn't have a lot of sizzle."

Recipe for Reform

William E. Philbrick, a former IRS examinations chief and now tax director and senior vice president at Greenberg, Rosenblatt, Kull & Bitsoli P.C., suggested that serious reform is a legislative pipe dream. He predicted that a few lawmakers in the next Congress might bring up flat taxes or minor

tax tweaks, but that eventually the debates would fade and lawmakers would settle for selective adjustments, rather than tackling the tough changes.

"I don't foresee simplification rising to the top," Philbrick said. He further criticized lawmakers for fixating on minor issues like the tax treatment of interest payments on student loans while allowing tax shelters to multiply exponentially — a myopic strategy he said has traditionally led Congress to "bring an elephant gun to shoot a mouse."

Olson said simplification could certainly happen in the next administration, assuming the incoming president can quell the partisan squabbling on Capitol Hill.

"I sort of feel like for the last four years everything has come down to if one side says 'A,' the other side says 'not A,'" she said. "At some point we have to put down our slings and arrows and lay down our excessive concern about who's in control . . . and just say 'For the good of the country, we've got to agree on some things' and move forward."

Weinberger said that although mending fences might help a little, the only way simplification would take hold on Capitol Hill is if the electorate clamors for change.

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"It's going to take the American public to really press the scale down and scream and holler in order to get that high enough on the radar screen that it becomes the objective for a bill," he said. But lawmakers would need to frame the debate by showcasing the tradeoffs involved — like eradicating the home mortgage deduction or dropping the various child credits — if they want an honest debate, according to Weinberger.

"When you ask it as an either-or, it's not as clear an answer . . . as just saying 'I'm for simplification,'" he advised.

Moody suggested that, honesty aside, revenue neutrality might derail Bush's reform efforts — particularly because many of the president's tax changes have effectively created new constituencies for the targeted tax benefits he now seeks to excise.

"It's kind of ironic that Bush's policies in the first term . . . will actually make his goals in the second term harder to achieve from a political standpoint," Moody said. "Unless of course you throw revenue neutrality out the window and make it a tax cut."

Keating advised the new tax leaders — whoever they might be — to use their time wisely by chipping away at the monolith their predecessors

have erected. "What they should be focused on is a tax system that does the least harm to the economy per dollar raised," he told Tax Analysts. "And simplicity, and certainty, and low tax rates can all be a part of that package." ■