

Testimony
of
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before the

U.S. Senate Committee on Finance
March 10, 2015 10:00 a.m.

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is a pleasure to appear before you today to discuss tax complexity and the importance of simplification. I am a Professor of Finance at Harvard Business School, a Professor of Law at Harvard Law School and a Research Associate of the National Bureau of Economic Research.

Complexity in the tax code has negative redistributive and growth consequences that have only accelerated over time as more and more policy goals are now implemented through the tax system. My comments attempt to outline briefly the harmful effects of complexity, particularly egregious examples of complexity, and a proposal for remedying complexity in the tax code.

1. Our complex economy must be matched with thoughtful and detailed tax rules. As such, railing against all complexity is naïve. Instead, the types of complexity that deserve our attention are either i) when taxpayers have difficulty in complying with the law, ii) when the IRS cannot enforce the laws, or iii) when complexity gives rise to planning opportunities.

Compliance complexity is most prevalent with individual taxpayers and small businesses. The web of education incentives in the tax code provides a paradigmatic example of such complexity. Compliance complexity retards efforts of policymakers by reducing uptake, increases the likelihood that the behavior rewarded with tax expenditures is inframarginal (leading to windfalls to taxpayers rather than to the desired changes in behavior), and redistributes wealth toward sophisticated taxpayers and tax advisers who can manage this complexity.

Administrative complexity is most common with business taxes and is manifest, for example, when the IRS relies on the actions of auditors, as independent verification is often beyond the abilities or resources of the IRS. This type of complexity again rewards sophisticated taxpayers and investment in non-productive activity but also creates a crisis of confidence in the tax code when taxes effectively become optional for sophisticated taxpayers. [See Reference 4]

2. The final type of complexity arises from a “call and response” pattern of tax planning by practitioners that provokes more detailed, bright-line rules by administrators that, in turn,

triggers new tax planning opportunities and so on. This death spiral of planning-regulation complexity is evidenced in the most important area of business taxes – international tax rules – where complex rules govern an unwieldy system that raises little revenue. As a recent example of this dynamic, last year’s Treasury notice designed to prevent inversion transactions will have the primary effect of transferring wealth to foreign multinational firms and those firms that inverted prior to the proposed regulations as they have become advantaged acquirers of U.S. assets. Indeed, several years of anti-inversion legislation and rules have only served to increase the planning activities around mergers and the real distortions undertaken to achieve tax savings.

3. Recent proposals to enact an alternative minimum tax on foreign source income within a proposed territorial regime provide the latest example of the vices of this planning-complexity dynamic. Such proposals attempt to prevent planning by implementing a *de facto* worldwide system of taxation without deferral at, for example a nineteen percent rate, on a per country basis but label it a territorial regime. It would be preferred to explicitly repeal deferral within a worldwide regime rather than to enact such a “backdoor” worldwide regime – much as today’s worldwide system that functions as territorial is much worse than a true territorial regime. Such complexity creates numerous opportunities for planners that have resources that far eclipse the ability of the government to police them – and their efforts will trigger a new round of regulations with further distortions and more planning opportunities. A simple territorial system as implemented by governments around the world, with anti-abuse provisions and a simple adjustment to address expense allocation, provides the best alternative to ensure that the corporate tax systems advances, rather than retards, the interests of American workers and firms. [See References 5, 6 and 7]
4. Addressing complexity in the tax code requires analogizing to other complex systems and drawing on the research that demonstrates how to manage that complexity. In short, the complexity of the tax code could be managed much as the complexity of software code is managed. This analogy yields two primary lessons. First, “over the wall” engineering is highly problematic and “concurrent” engineering is preferred. Throwing completed ideas “over the wall” to the next part of the production process limits learning and engenders complexity relative to a concurrent and iterative production process. Currently, policy ideas are often developed without a clear vision of the associated language and with even less attention to the perspective of administrators. The practice of policy formulation and drafting must be a collaborative activity with the administrative agency in charge of enforcement. More consistently following and strengthening the recommendations in Sections 4021 and 4022 of The Internal Revenue Service Restructuring and Reform Act of 1998 would provide for a considerable bulwark against creeping complexity by preventing “over the wall” engineering.
5. Second, and more radically, we could embark on an effort to open up the administrative and legislative process in order to effectively “crowdsource the code.” Effective management of complex codes – be it Linux or the tax code - requires three steps. First, a code must be mapped so that the interrelationships, technically and conceptually, of the different parts of the code become manifest. Second, this mapping enables modularization whereby the code is reorganized into pieces that reflect these

relationships. Finally, this modularization provides the foundation for opening up the code to experts throughout society who contribute suggestions for rationalization and simplification. [See References 2, 8, 9, 10, and 11]

6. Currently, the code, to the degree its complexity is managed at all, is managed much as it was fifty years ago - in a fundamentally closed manner. Laws and administrative guidance are drafted by small groups in a non-transparent way that pays little attention to the overall architecture of the tax system. As a consequence, vested interests influence the management of complexity toward their advantage and complexity grows by ignoring interrelationships.
7. By mapping, modularizing and opening the code and associated guidance we could draw upon widespread expertise, provide transparency on a critical process, address the imbalance in resources between the taxing authority and sophisticated taxpayers and begin the process of simplifying the code and the associated administrative guidance. A modest manifestation of the power of crowdsourcing ideas on the code is provided in Appendix A, which compiles the suggestions of twenty experts on complexity. In the limit, one could imagine a detailed mapping of the tax code and associated regulations much as software code is mapped. This mapping would then serve as a guide to reorganizing laws and regulations over time. While decision making rights would remain where they currently reside, opinions on policies would then be solicited widely and the drafting of laws and regulations could be aided by experts around the country through an open platform.
8. Finally, three structural features of our tax system most contribute to complexity. First, consumption taxes have major simplification advantages over income taxes as the base is more readily identified, particularly given the growing importance of cross-border flows and intellectual property. Second, the reliance on realization events engenders great complexity that could be alleviated by considering accrual taxation in some settings. Third, the reluctance to embrace solutions that provide taxpayers with the information that tax authorities already have, as with ReadyReturns, is a major cause of unnecessary complexity in the individual arena. Structural reforms that address these sources of complexity would allow for considerable simplification. [See References 1, 3, 4 and 12]

I look forward to your efforts in this important area and I'd be delighted to answer any questions.

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Appendix A
Identifying Excessive Complexity in the Code

This appendix provides an anonymized catalog of responses from twenty-one tax experts when asked about areas of excessive complexity

#1

An obvious candidate for excessive complexity are the "anti-NOL-trafficking" rules of section 382 and the regulations thereunder, especially the aspects of the rules that require a corporation to identify and track 5+% shareholders or "public groups" of shareholders to determine whether there has been an "ownership change" with respect to the corporation, in which case its ability to use its pre-existing NOLs and other tax attributes to shelter future taxable income is limited. The IRS has in the last few years issued some regulations that ease the burden of applying these rules, but they are still inordinately complex in their application.

#2

Section Code 704(b):

(b)A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

- (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or
- (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

In English, this means that allocations of income are dictated by the partnership agreement. If, however, the such an allocation does not have "substantial economic effect," then the correct allocation for tax purposes will be determined by the "partner's interest in the partnership" (i.e., the real economics of the deal.)

The real complexity is in the 704(b) regs. Take a look. They are astounding. The regs provide various safe harbors. So complex, in fact, that they are mostly disregarded in private equity funds, as many funds opt not to try to comply with the rules, and instead rely on the baseline rule in the statute that if an allocation does NOT have substantial economic effect, then the correct allocation will be determined by the "partner's interest in the partnership."

There are a couple of simplification options. One option is to abolish non-economic or "special" allocations.

Another is to eliminate subchapter K and instead tax all partnerships through the subchapter S rules (with some minor modifications). I think Dave Camp proposed this as an option. Perhaps the easiest, politically, is simply to revise 704(b) to make the baseline rule of "partner's interest

in the partnership", i.e., tax follows economics. There will obviously be some cases where it is unclear whether a tax allocation does in fact follow economics. But most partnerships are concerned with business goals, not tax avoidance, and it's not like current law makes it easy to police tax avoidance. So let's make it easy for the vast majority of partnerships that just want to accomplish business goals.

#3

- A. Examples that affect reasonably ordinary events or a large number of people - the capital gain rules for individuals' business property and the earned income tax credit.
1. I buy a computer in 2014 and sell it in 2015. For basis I go to 1011, 1012, 1016 (subtracting applicable 179 expensing (if elected) and 167/168 depreciation). Amount realized should be simple assuming I do not take back a note. I go to 1223 for my holding period. If the computer is used (in whole or in part) in my business, 1245 depreciation recapture will apply, and gain in excess of depreciation goes through 1221(2) to the 1231 hotchpot. If some gain is capital, it goes through 1222 waterfall. I have to apply 1(h) rate rules. It is worse if it is real property used in my business because of 1250 and 1(h). This could be a lot simpler without having to shift to a consumption tax (where other problems arise).

Quick fixes (without much thought): As in 1986, repeal preferential capital gain rate (especially if overall rates go close to 30%) and allow all capital losses (short- and long-term) to net; repeal 1231 under any circumstance; if preferential capital gain is retained make it a percentage deduction.

Counter argument: This is mostly calculation complexity and can be done on TurboTax, which most business people can use.

2. EITC: I would just send you to the pages in the 1040 instructions for the EITC to prove this point. Nina Olson's National Taxpayer Ombudsman Report of a few years ago highlighted EITC among a series of complexity issues and it is annually on the list of highest erroneous government payments.

Quick fix: Make the credit/refund a percentage of payroll/self-employment tax paid keyed to filing status and family size - Nina's report may have had a better idea.

Counter argument: There really is not a good one if we insist on using the tax system to transfer payments.

Taxing a child's investment income at parent rates is incredibly complex but affects fewer people and rich kids (or kids of rich parents) tend to be less sympathetic.

- B. My second response is that every formal taxpayer election (not to mention de facto elections) increases complexity because it calls for running the numbers both ways (not that everyone does). I question the need for 95% - 99% of the formal elections in the Code. If it is necessary to use an election, the rule is a bad one or a political itch is being

scratched. But each one must be coded, monitored by the IRS and thought about by taxpayers and advisers. There are hundreds.

Two of many possible sources for ideas are: New York State Bar Association Tax Section Report 1007, Simplification of the Internal Revenue Code (March 18, 2002) and JOINT COMM. ON TAX'N, RECOMMENDATIONS FOR SIMPLIFICATION, Vol. I (sources of tax complexity generally), Vol. II (April 2001) (specific categories of issues).

I worry less about complexity for very sophisticated and rich taxpayers (most MNEs, PE funds and portfolio companies and high net worth individuals and trusts). I also would not give them elections.

#4

Get rid of the individual and corporate alternative minimum tax. Why should you have to calculate your tax, and then calculate it again another way. If Congress does not like certain preferences, then they should be eliminated.

For a while I filled out my father's tax returns. He lived in NJ, a high-tax state. One spring I filled out his Form 1040 and calculated his regular tax. Then I told him we had to fill out another form (6251) to calculate whether he owed AMT. He was outraged. He said: "I am 80 years old. I do not pay this alternative minimum tax." I said: "There is no exception for octogenarians." He said, "You're fired!" I said, "You can't fire me. First of all, you aren't paying me anything to do this. Secondly, I am your son - you can't fire your son." He said: "You wanna bet? You're fired." In the end he owed AMT.

#5

Another question is the type of complexity. Education incentives, e.g., are easy to comply with--just plug everything into TurboTax and see what comes out--but present complex incentives since no one really knows how they're affected at the time of the expenditure. OTOH, tracking deductible business expenses is complicated and time-intensive, but the rule is easy to understand. Then, of course, there are those provisions that just don't make sense and you need armies of lawyers to interpret.

I think the original sin of most of the worst complexity in the Code is the realization requirement--again, easy to understand, but creates enormous problems.

#6

I find the IRA rules to be unconscionably complex, particularly in that the complexity falls on individual taxpayers. I would cite the contribution limits, especially for retirement-plan participants (section 219), eligibility for Roth contributions (section 408A), the excise tax for

getting the contribution limits wrong (section 4973), the age 70-1/2 distribution requirements (sections 408(a)(6) and 401(a)(9)), the other distribution rules (section 408(d)), and the numerous exceptions to the 10-percent early withdrawal penalty tax (section 72(t)).

#7

Some of the most complex areas of the US tax rules pertain to the taxation of foreign income. The following is a summary of some of these complex rules. We can provide additional detail, if useful.

Foreign tax credits: There are highly detailed and complex rules relating to foreign tax credits e.g., IRC 901-909

- Certain of the rules are designed to limit credits only to foreign levies that are a tax on net income.
- Other rules are designed to prevent the cross-crediting of high taxes on one stream of income against another stream of low-taxed foreign-source income.
- Income and associated taxes are split into separate groups – so called “baskets” (i.e., taxes in one basket cannot be credited against income in another basket). Generally, income/taxes are separated into a “passive” basket (which includes dividends, interest, royalties, rents and similar income not derived in connection with an active business) and a “general” basket (other income), with high-taxed passive income (i.e., income subject to foreign tax in excess of the US rate) being excluded from the passive basket.
- Intercompany dividends, interest, royalties and rents are characterized on a “look-through” basis by reference to the underlying earnings from which the amount is paid.
- There are complex rules (the so-called “splitter rules”) – designed to address circumstances where the entity treated as the taxpayer for foreign purposes differs from the entity treated as earning the income for US purposes. The purpose of these rules is to match the income with the associated tax for US tax purposes.
- This may arise, for example, where income is earned by an entity that is fiscally-transparent (e.g., a partnership) for foreign tax purposes but that is treated as a separate corporation for US tax purposes.
- This can also arise under foreign rules governing the taxation of affiliated groups (e.g., one entity pays the tax on behalf of the entire group; or losses are “shared” within the group).
- There also are rules designed to address “base differences” – i.e., the tax base for foreign purposes differs from the tax base for US purposes.
- Foreign tax credits are computed on a pooled basis for CFC’s (with foreign tax redeterminations treated as adjustments to the pool) and on an accruals basis for US taxpayers and for foreign branches of US taxpayers.
- Excess foreign credits are carried forward up to 10 years.
- There are complex rules governing losses – e.g., generally, if a net foreign-source loss reduces US-source income in one year, subsequent foreign source income is re-characterized as US-source income. A similar rule is applied if a net loss in one

foreign tax credit basket offsets income in another basket, or if a net US-source loss offsets foreign-source income in a year.

Interest allocation: There are highly detailed and complex rules governing the allocation of US interest expense to US-source and foreign-source income – e.g., 861, 864. These rules apply under current law for purposes of computing net foreign source income in connection with foreign tax credits. They also form the basis of the interest-allocation proposal in the Administration’s budget, denying deductions for US interest expense allocated to earnings of foreign subs (or branches) that are not subject to US tax.

- Subject to certain exceptions, Interest expense is allocated to US and foreign-source income based upon the relative value of the US-group’s US and foreign assets. Income allocated to foreign assets is then allocated among assets within each foreign tax credit basket.
- The value of US and foreign assets is generally determined by the US tax basis in the assets. Taxpayers may elect to determine the value of assets based upon fair market value - which is a complicated and costly analysis.
- In many cases, a complex analysis is required to determine the type, or split, of income produced by an asset (e.g., an intangible).
- There are some complex (and incomplete) rules addressing the treatment of certain types of interest equivalents, including derivatives entered into as hedges.
- There are complex rules addressing the treatment of intercompany funding.
- These include the so-called “CFC netting” rule- designed to limit the creation of net foreign-source income through the combination of US borrowing and intercompany funding (i.e., US interest expense is allocated between US and foreign income, and US loans to foreign subs generally produce all foreign source income).

Subpart F rules: There are highly detailed and complex rules providing for the current US taxation of certain types of income of a CFC – e.g., IRC 951-961. This is generally income considered to be passive or highly-mobile.

- This includes so-called “foreign personal holding company income” – e.g., dividends, interest, royalties, rents and other similar income.
- There are complex rules for excluding such income from taxation, when derived in the course of an active foreign business. One such provision, the “active financing exception,” is part of the set of “expiring provisions” that have needed to be re-enacted on a regular basis.
- Under another “expiring provision,” the “CFC look-through” rule, dividends, interest, royalties and rents paid between CFC’s are excluded from Subpart F if allocable to underlying earnings that are not taxable under Subpart F.
- Current taxation under Subpart F also applies to so-called “foreign base company sales income” – which is generally income of a CFC derived from i) the purchase of property from a related person or the sale to a related person, ii) where the property is manufactured outside the country in which the CFC is located and the property is sold for use or consumption outside the country.
- There are complex rules for determining whether the property has been “manufactured” in the country where the CFC is located – e.g., whether the CFC has made a “substantial contribution” to the property.

- And, there are rules for determining whether the property has been sold for “use or consumption” in the country where the CFC is located.
- There are also complex rules applying similar principles to branches of CFCs.
- Similar taxation applies to “foreign base company services” income.

Comment:

If the US adopted an exemption system (without a foreign minimum tax), the complexity of the foreign tax credit rules would be eliminated, except to the extent needed in connection with continuing Subpart F rules (discussed below).

Similarly, complexity would be avoided if the exemption system did not include interest allocation as a limitation on the deductibility of interest expense. In part because of concerns about complexity, many countries have opted for an exemption “haircut” (e.g., 5% inclusion) in lieu of expense allocation.

Under an exemption system, there likely would be a continuing need for the current taxation under Subpart F of passive foreign personal holding company income. However, it’s questionable whether the foreign base company sales or services rules should be retained on foreign-to-foreign transactions (i.e., the transactions result in a reduction of foreign tax, not an erosion of the US base). This would be another area where complexity could be eliminated.

#8

The “straddle” rules of Section 1092, which govern offsetting positions. Especially complex are the “mixed” straddle rules, where one of the offsetting positions is marked to market.

The New York State Bar Tax Section did a report in 2002 with some examples of unnecessary complexity. It’s at the following link.

<http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1007report.pdf>

They mention two more examples -- the “fractions rule” and the rules for netting capital gains.

#9

The rules for corporate tax, partnership tax, tax accounting, and insurance tax are other examples of extremely complicated tax rules. Indeed, if I were asked to name the single most complicated and difficult rule in the US tax system, I might name the rule on “deferred intercompany transactions” under the regulations for consolidated tax returns (the rule in Reg Sec. 1.1502-13). The standard treatise on consolidated tax returns devotes approx. 400 pages to the discussion of this single rule (the author of the treatise, an extremely capable and talented tax lawyer, wrote the rule when he was at Treasury’s Office of Tax Policy).

#10

There are a lot of insanely complicated corporate tax provisions, but those usually don't get much sympathy because they mostly affect corporations that hire Big 4 accounting firms to work out the results. As to individual tax returns, but two obvious cases are the individual alternative minimum tax and the passive loss rules (for the high earners) and the earned income tax credit (for the low earners). Even the AMT and passive loss rules don't get a lot of sympathy because TurboTax automatically deals with a lot of the complexity.

#11

Section 382 and its regulations are extremely complicated. To determine whether use of a corporate NOL, capital loss or credit carryover is limited, you have to determine if there was an ownership change of the loss corporation, which is basically a more than 50% shift in ownership over the prior 3 years. To determine if there is an ownership change, you have to identify all 5% shareholders and determine if their equity interest has increased in the past 3 years and by how much. But if a corporation is owned by another entity or entities, you have to look through the upper entities to look for 5% shareholders and their ownership shifts. Besides the difficulty of finding out who owns an upper tier entity (if that is possible), there is a rule that says all less than 5% shareholders are together treated as a single 5% shareholder whose ownership has to be tracked, but in some cases you need to segregate these public groups into smaller groups and track the smaller groups. Identifying and tracking ownership shifts under the rules is very difficult, but the stakes are enormous, because if there is an ownership change the use of attributes can be severely limited or nearly wiped out.

To add to the complexity, the rules apply not only to NOLs, but also built-in losses. If a corporation has assets with overall basis greater than FMV, and it undergoes an ownership change, then if the built-in losses are recognized within 5 years after the ownership change, use of those losses are limited. So at the time of the ownership change you have to know if the corporation has an overall built-in loss and you have to know, for every asset you sell at a loss within 5 years after the ownership change, whether that asset had a loss in it at the time of the ownership change and the amount of that built-in loss at the time of the ownership change.

And then there is the application of the section 382 rules in a consolidated group. What a combination of two incredibly complicated areas. Just scratching the surface of the additional complexity, for example you need rules for members coming into and leaving a group. There are few people who really understand the consolidated section 382 rules.

I also note that there are special AMT rules if a corporation undergoes an ownership change.

Practice of tax law has gotten to the point where it is nearly impossible to be a generalist. There is too much to know and it's too hard to understand. It's not just federal tax law, it's state and foreign tax law too.

And if you think it's hard for practitioners, think about how hard it is for the IRS, which has to administer the entire Code, including such varied programs as the EITC, energy provisions, FATCA and healthcare.

#12

Complexity is relative. Different situations merit different levels of complexity; and the question is whether the rules are unduly complex for the specific situation.

Take the US partnership rules, for example. Over the years, aspects of the partnership rules have been criticized for being overly complex; and the IRS has issued revisions to the rules in part in response to such comments. Much of the complexity in the partnership rules, however, pertain to special allocations of income/losses. The rules could be simplified by limiting special tax allocations. However, the business and investor community would presumably object because this would take away one of the principal benefits of operating in partnership form.

Financial products is another area with complex rules. Here again, there has been some criticism of the complexity of the rules. However, the subject matter is very complex. A bigger issue with financial products is that the products continually evolve; so there is a constant issue of the rules needing to “catch up” with today’s products.

One issue that this discussion raises is the choice between alternative types of rules. At one end of the spectrum are very detailed rules applicable to specific fact patterns. This approach provides certainty in the results of the fact patterns addressed, at the risk of leaving open the treatment of other fact patterns. At the other end of the spectrum is a limited set of rules that represent guiding principles to be applied to different fact patterns. This approach provides flexibility to address a broad range of fact patterns, with less certainty in results.

It’s interesting, because the consolidated return rules mentioned in Marlin are, in concept, an example of the second type of rules. They are designed to provide a limited set of guiding principles to govern the taxation of intercompany transactions within an affiliated group. However, the rules contain so many examples that the examples have come to be viewed as largely defining, as opposed to illustrating, the rules.

As far as complexity in the context of the international tax rules: international business operations are complex, which suggests some unavoidable level of complexity in the international rules. However, there seems to be an opportunity to reduce the complexity in changing to a new (exemption) system - which achieves other benefits as well.

#13

There are certain parts of the tax code that are "complex" in the sense of being very difficult because of certain conceptual challenges. Subchapter K is a good example in my view. The total quantity of rules is not great, especially when compared to other areas of the Code. Instead,

the complexity is generated largely by the fundamental tensions between the aggregate and entity theories of partnership and how that tension makes it so difficult to resolve a number of issues (plus there are many issues that simply lack guidance). This is difficult material to be sure, but not "complex" apart from the extreme difficulty.

Another strain of complexity is found in areas of the Code which are very formalistic and often contain multiple traps for the unwary. Section 305 (stock distributions) is like that, as are a number of the reorg provisions in subchapter C (which can be exceedingly formalistic).

Perhaps more relevant are areas of the Code where there are these intricate rules upon rules. These are areas where, instead of wiping the slate clean and starting over again, Congress and/or Treasury continues to layer floors and floors of rules upon a fundamentally shaky foundation, so that the end result is a maze of rules that are very hard to navigate. I think Section 382 (the section on trafficking in NOLs) is one example -- is that really such a big problem that we need hundreds of regulations to combat it? But I think perhaps the best example is the foreign area, where the entire process with Congress and Treasury seems to be one giant "whack a mole" exercise. The 7874 rules that we discussed is a good example (with it having gotten so bad that folks are now worried that totally innocent cross-border transactions that aren't meant to be inversions can nonetheless get caught by 7874). The 367 rules governing cross-border reorgs are a monument to complexity -- hundreds of pages of temp and regular regs that do not mesh well at all and are remarkably confusing. The foreign tax credit rules are another area, especially after the 909 splitter and 901(m) restrictions came into law.

#14

What I find perplexing is that the Code is riddled with complexity even for basic fact patterns affecting the general taxpayer. It's hard to build trust in the tax system when the average American needs to hire an outside professional to prepare his/her tax return. I have prepared tax returns for low income taxpayers who have to navigate complicated rules such as the definitions for single/head of household, dependents/qualifying persons, earned income credits and the litany of other rules that should be basic law for someone who clearly has no financial background. And, this permeates the entirety of the Code. It affects us all because it feeds the notion that the tax law is rigged and only benefits the business or person who can retain high priced talent to benefit from "loopholes" in the system.

#15

1. Allow small business greater use of the cash method of accounting. The Bush Treasury allowed the use of the cash method to a wide swath of small businesses. The Obama budget has proposed expanding it to businesses with up to \$25 million of receipts. It would allow many small businesses to file their taxes with little more than their checkbook registers of bank statements.

2. Increase small business expensing. The Obama budget takes the expensing limit up to \$1 million. Combined with use of the cash method, this proposal would represent significant simplification for small business.
 3. Repeal the uniform capitalization rules of section 263A and replace with book capitalization rules. This one wasn't allowed out of the building. Revenue estimators insisted it would lose revenue. The accounting experts at Treasury insisted section 263A loses revenue because it invites companies to redo their book capitalization, which inherently favors capitalization, and to expense everything they possibly can.
 4. Combine the multitude of tax preferred savings accounts into two simple accounts, one for retirement savings and one for everything else. We called the retirement account simply "retirement savings account" and the all-purpose account "lifetime savings accounts". The accounts attracted more excitement than any proposal I've ever worked on from Ph.D. economists to ordinary Americans. I believe the proposals would have been hugely beneficial for families of moderate means because they were simple to understand and didn't require that funds be set aside untouchable except for particular purposes, which deters moderate income individuals from using tax preferred savings vehicles at all.
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#16

Foreign tax credit provisions are incredibly complex. To claim a foreign tax credit a firm has to (1) determine the payment to the foreign government is a "tax" (i.e., a mandatory payment that is generally applicable and for which it does not receive a "specific economic benefit, (2) that the tax is an "income tax" in the U.S. sense (i.e., you must apply U.S. tax principles to foreign law to see if the tax is based on net income, (3) you must then determine the amount of your (a) foreign source gross income and (b) your foreign source deductions (by following a series of extremely complicated rules set forth in the regulations...including separate allocation rules for separate kinds of income--e.g., interest), (4) allocate the foreign source income and foreign source deductions among various "baskets" (passive, active, high tax, oil related, etc), (5) subtract the allocated expenses in each basket from the income allocated to that basket to determine the foreign source taxable income in that basket, (6) determine the ratio of the foreign source taxable income in each basket to worldwide taxable income to determine whether there is a limit that applies to the allowable foreign tax credit, (7) work through any carry overs or carry backs of excess foreign tax credits from prior years...and all the while make sure you are on the right side of a broad set of anti-foreign tax credit stripping rules that require an entity-by-entity determination of current income and deductions, and historic pools of earnings and profits.

By contrast all of this complexity disappears under a territorial system.

#17

The complexity of some of the US rules - eg, regulations relating to interest expense allocation - creates at least as much difficulty for the IRS as for taxpayers and leads to real questions about administrability and fairness. Policymakers should have this in mind in the context of tax

reform, or in connection with multilateral initiatives such as BEPS (where unadministrable rules can lead to double tax and cross border disputes).

#18

A few of the areas of areas of complexity worth noting are:

1) The dual consolidated loss rules. It is a relatively brief statute found at section 1503(d), but the regulations at 1.1503(d)-1 through -8 are (as the citation suggests) very extensive.

2) The overall foreign loss ("OFL"), separate limitation loss ("SLL"), and overall domestic loss ("ODL") rules are another good example of complexity (and maybe an even better example of how complexity inevitably breeds further complexity). You start with a foreign tax credit system to prevent double taxation (which sounds simple enough), but then you need FTC limitation rules to prevent using credits to offset tax on US income; that requires a universe of income sourcing rules (a subject for another time). Then you need different baskets of foreign source income to prevent "inappropriate" cross-crediting (and of course the number of baskets has ebbed and flowed over time as perhaps further evidence of the battle between "precision" and "complexity"). Once you have baskets and FTC limitation rules you need OFL and SLL rules to preserve the integrity of those categories "across time." So taxpayers need to track all their different items of income, "source" them, "basket" them, and then track those categories over time using multiple OFL and SLL accounts, with the result that once you have sourced and basketed income you may have to re-characterize that income in any given year based on what happened in prior years. Having done all that for foreign losses to backstop the FTC limitation rules, it's only fair to have overall domestic loss rules to ensure that taxpayers aren't inappropriately denied credits over time. So the ODL rules are introduced into the Code. And then you need extensive regs telling you how all these pieces are supposed to fit together. For citation purposes, the OFL and SLL rules are found at section 904(f) of the Code, the ODL rules are in section 904(g), and the regulations are all under 1.904(f)-1 through -12 and 1.904(g)-1 through -3.

3) Another set of rules that we didn't discuss, but which are extensive, ever-changing, and complex are the regulations under section 367. That Code provision is basically meant to override or turn-off the non-recognition rules in certain cross-border transactions, and the regulations under those rules are voluminous (to say the least), with several outstanding Notices describing yet more regulations to be written under those statutory provisions.

#19

The number of tax brackets is not a source of complexity in itself in an era of e-filing (though the lumpy effective marginal rate schedule probably is), even though that's where the political rhetoric goes. Also, the realization requirement, coupled with 1014, is perhaps the biggest single source of complexity. It creates huge differences based on character and timing, and so we then have numerous provisions to police it. If we had mark-to-market, we could get rid of a corporate

tax, get rid of constructive sale rules and associated planning, tax accrued gains at the same rate as ordinary income (thus minimizing character issues), stop a lot of the debt/equity issues-- maybe even get rid of the estate tax, if we are otherwise effective at taxing inter vivos wealth accumulation. So when people say mark-to-market is "too hard" or "too complex," I'm confused.

Here are some specifics on education. So many overlapping and conflicting provisions that I think it's hard for a taxpayer to plan effectively, and as a result I'm skeptical that these have much incentive value. I think they are likely just pure redistributive transfers, likely shared with the institutions.

- Section 222 provides an above-the-line deduction for qualified tuition, but only in certain situations, and with discontinuous income-based caps and no phase-out or inflation adjustments
 - The allowed deduction is also limited in cases where the Section 25A credits apply and where the tuition was paid out of a 529 account.
- Section 25A provides for two somewhat overlapping tax credits, the Hope Credit and the Lifetime Learning Credit, with different benefits, applicability, eligibility, and inflation-adjusted phase-outs.
 - These are somewhat simplified by temporarily making the Hope Credit more generous (larger, refundable, slower phase-out) and renaming it the American Opportunity Tax Credit under § 25A(i), but that expires 2018, so it will be subject to the typical extender nonsense, probably not being resolved until after students make expenditure decisions.
- There are multiple forms of education savings accounts, each with their own kludgy rules.
 - 529s create gift tax issues and allow trades only twice a year. § 529(b)(4). I assume that's for paternalistic reasons, but it also stops appropriate rebalancing.
 - The state/federal structure is weird too.
 - There are also Coverdell Education Savings Accounts under § 530, with different rules, definitions of applicable expenses (private school, not just college), more investment flexibility, but income limitations that 529s don't have.
- Let's throw in loans and financial aid while we're at it:
 - Pell Grants and subsidized loans that require different eligibility determination, using FAFSA instead of tax return
 - But IBR and PAYE loans also, which do use tax return information.
 - These also have political risk, including whether or not forgiveness will be taxable.
 - Plus loan interest is deductible in some cases, under § 221, but with income phase-outs, etc.

#20

Section 382 and the regulations is one of the most complicated tax provisions.

Others that rank high in complexity:

1. Almost any Code section that requires resort to the Section 318 attribution rules, which apply to 8 other Code sections, per the Code, and are incorporated by reference in some additional places in the regulations.
2. Section 367, which changes/affects the result in exchanges described in sections, 332,351,354,356, or 361, as well as certain other cross border or outbound transfers. subject to exceptions included in the Code and the regulations, special rules for partnerships, special rules for deeming certain transfers to be “exchanges,” and special rules for transfers of intangible property within the meaning of section 936(h)(3)(B).
3. Section 409A and a voluminous set of regulations which sets forth some extremely complex rules governing the timing, form and tax treatment of nonqualified deferred compensation payments. (For example, the rules require meeting specific requirements related to the time at which the initial decision to defer the compensation is made, prohibiting any later changes to the timing of the payments (i.e., they can’t be further deferred unless very strict rules are met, and they cannot be accelerated), limiting the time at which payment can be made to certain fixed events or dates, including death, disability, termination of service, change of control, or a fixed date set at the time the plan is adopted....and each of these payment dates (other than “death”) has its own set of complex definitions, rules and requirements.)
4. Alternative minimum tax for individuals

Other sources of complexity for individuals include phase outs, the multiplicity of rules applicable to pension and saving plans (e.g., traditional IRAs, Roth IRAs, profit-sharing and employee stock option plans, 401(k) and 403(b) plans).

#21

1. Limitations on the foreign tax credit.
2. The application of subpart F to partnerships
3. Expense allocation for purposes of determining the allocation of deductions to foreign source income (relevant for foreign tax credit limitation purposes).
4. Complex in a different way: application of the various anti-abuse rules and doctrines in the code and case law, including the economic substance doctrine.
5. The withholding and reporting rules on cross border payments, including but not limited to FATCA.