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Tax Simplification

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*Congressman Michael A. Andrews**

AS the 103rd Congress considers tax legislation, one area that should be examined in the context of American economic growth and competitiveness is tax simplification. But whenever Congress attempts tax simplification, the more complicated the Internal Revenue Code (I.R.C. or the Code) appears to become.[1] Some tax policy analysts, however, argue that we have made progress. During the floor debate on the passage of the Tax Reform Act of 1986, Congressman Dan Rostenkowski, Chairman of the Committee on Ways and Means, held up the old Tax Code and the new, proposed Tax Code to show the difference in size. The old Code was about the size of the Dallas and Houston Metropolitan phone books combined; the new Code was about the size of the Fort Worth phone book.

The Tax Reform Act of 1986 did make significant strides in simplifying the Code, and Chairman Rostenkowski deserves much of the credit. However, while size is one way to measure progress, it alone is insufficient to those who attempt to interpret the Code. In tax writing, brevity does not necessarily mean simplicity. In fact, some tax practitioners say that more specificity in statutory language and Internal Revenue Service (IRS) regulations and revenue rulings makes application of the Code more straightforward.[2]

The Tax Code is too complex;[3] on this point, most people would agree. In the words of Huckleberry Finn upon reading *Pilgrims Progress*: "It was in-

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1. 26 U.S.C. §§ 1-9602 (1988 & Supp. IV 1992) [hereinafter I.R.C.]. One commentator's analogy concerning Congressional efforts to simplify the Tax Code deserves mention and at least qualified acceptance: "When Congress talks about simplification, taxpayers may well be reminded of Emerson's comments regarding an acquaintance, '[t]he louder he talked of his honor, the faster we counted our spoons.' " Michael J. Graetz, *The Truth About Tax Reform*, 40 U. FLA. L. REV. 617, 634 (1988).

2. *See, e.g.*, Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1, 2-10 (1974). For an excellent analysis of the pros and cons of detailed tax statutes, see Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673, 695-703 (1969); Graetz, *supra* note 1, at 1-2, 10-11.

3. One commentator has suggested three different interpretations of "complexity": "technical complexity," the pure intellectual difficulty of understanding the meaning of I.R.C. language; "structural complexity," the difficulty of applying specific tax rules to economic transactions vis-a-vis tax planning; and "compliance complexity," the record-keeping and form-completion requirements that full compliance requires. Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 5 WIS. L. REV. 1267, 1271 (1993).

terestin' but steep."[4] A tax on income must take into account a near infinite spectrum of business and investments and personal economic transactions and events.[5] But complexity is in the eye of the beholder when it comes to the hard choices of tax policy. In my experience on the Committee on Ways and Means, no beneficiary of a new provision has ever rejected it because of its complexity.[6]

Chairman Rostenkowski wisely designated 1991 as the year of tax simplification.[7] The Chairman, together with Congressman Bill Archer, the Ranking Minority Member of the Committee on Ways and Means, introduced The Tax Simplification Act of 1991 on June 26, 1991.[8] This measure was incorporated into H.R. 11, the Revenue Act of 1992, which was vetoed by former President Bush on November 4, 1992.[9] As with most legislation, the success of this bill should not be measured by great strides, but rather by small and important victories in the margins of tax policy. People constantly complain that Congress never does anything, that government moves too slowly on vital issues. James Madison would smile at those remarks. Careful deliberation is exactly what the Founding Fathers intended. Our government is designed to move for the most part by inches, not by great leaps.

There are compelling reasons to simplify the Internal Revenue Code.[10] A complicated tax code tends to undermine our system of voluntary compliance, the very cornerstone of federal tax administration. Full voluntary

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4. MARK TWAIN, HUCKLEBERRY FINN (1885).

5. Bittker, *supra* note 2, at 2.

6. "History records no instance of a taxpayer rejecting a proffered tax benefit on the ground it would further complicate the system." Ginsburg, *Whatever Happened to Tax Simplification?*, The 9th Herman Goldman Memorial Lecture, Record. Association of the Bar of the City of New York 769 (1987); "[N]o taxpayer group ever rejects a new tax preference on the ground it is complex . . . . In essence, all parties to the legislative struggle place substantive positions and results ahead of concerns over complexity." Surrey, *supra* note 2, at 691.

7. The Chairman initiated a major tax simplification study in February of 1990. He set standards which continue to be applied when assigning priorities to and assessing the merits of simplification proposals. The seven standards are:

a. Whether the proposal would significantly reduce mechanical complexity or recordkeeping requirements.

b. Whether the proposal would significantly reduce compliance and administration costs.

c. Whether the proposal would preserve underlying policy objectives of current law and neither create nor reopen opportunities for abusive tax planning.

d. Whether the proposal comports with generally accepted tax principles.

e. Whether the proposal would avoid significant dislocations of tax burdens among taxpayers.

f. Whether the simplification that the proposal would achieve outweighs the instability resulting from making any statutory change, as opposed to permitting statutory repose.

g. Whether revenue effects of the proposal would comport with current revenue and budgetary constraints.

STAFF OF HOUSE COMM. ON WAYS AND MEANS, 101ST CONG., 2D SESS., WRITTEN PROPOSALS ON TAX SIMPLIFICATION III (Comm. Print 1990).

8. H.R. 2777, 102d Cong., 1st Sess. (1991). A companion simplification bill was introduced in the Senate. *See* S. 1394, 102d Cong., 1st Sess. (1991).

9. H.R. 11, 102d Cong., 1st Sess. (1991). Parts of this bill were introduced on January 5, 1993 as The Tax Simplification Act of 1993, H.R. 13, 103d Cong., 1st Sess. (1993).

10. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), BLUEPRINT FOR TAX SIMPLIFICATION (1992) [hereinafter BLUEPRINT].

compliance is a direct function of taxpayer willingness to comply with the tax code. A complicated tax code requires many individual taxpayers, including businesses, to seek professional tax preparation advice, thus requiring an outlay of resources to an indirect source of income production.[11] Without professional return preparation, some taxpayers may not be aware of tax benefits to which they are entitled.[12] Furthermore, the complexity in the tax code gives some taxpayers the impression that if they take pains to understand the Code fully, they will discover new tax obligations.[13]

In addition, economic productivity is hindered by a complex Code's interference with business and personal decisions in that the after-tax implications of transactions are less certain. A complex tax code also results in increased IRS administration and enforcement costs, of particular importance as Congress searches for ways to reduce federal government spending.[14] One estimate shows the aggregate cost of the tax system approximating five to ten percent of tax revenues.[15]

This Article examines both some of the causes and some of the areas of complexity in the tax code and offers suggestions to foster its simplification. The first section discusses how the budget and tax legislative processes encourage complexity in the Code.[16] The next section suggests changes in these processes designed to alleviate this complexity. The final section discusses two substantive areas of the tax code that warrant simplification: the taxation of multinational corporations and pension regulations.

I. LEGISLATIVE PROCESS FOSTERS COMPLEXITY

The legislative process itself presents major obstacles to the pursuit of tax simplification. Because of the numerous policy goals of tax writing, tax simplification lacks the broad-based constituency normally required to pursue certain policy objectives.[17] This absence of a vocal public constituency only

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11. It is estimated that over one-half individual taxpayers feel it necessary to seek professional return preparation. *Public Hearing on President Clinton's Proposals for Public Investment and Deficit Reduction Before the House Ways and Means Comm.*, 103d Cong., 1st Sess. (1993) (statement of Leonard Podolin, Immediate Past Chairman of the Tax Executive Committee of the American Institute of Certified Public Accountants). Although the AICPA faces a reduction in their members' tax practice, the organization firmly supports Tax Code simplification.

12. For a detailed discussion of the complex Tax Code's impact on taxpayer equity, see McCaffery, *supra* note 3.

13. BLUEPRINT, *supra* note 10, at 3.

14. 1991 IRS ANN. REP. 7. The IRS reports that the complexity in the tax code requires modification of existing tax forms and instructions, annual reprogramming of Service computers, and constant retraining of Service employees.

15. BLUEPRINT, *supra* note 10, at 3.

16. This section draws heavily from Charles E. McLure, *The Budget Process and Tax Simplification/Complication*, 45 TAX L. REV. 25 (1989); *see also* Bernard Shapiro, *Complexity in the Tax Legislative Process: Problems and Proposals, Role of Congressional Staff and Taxpayer Representatives*, 1990 PROCEEDINGS OF THE INVITATIONAL CONFERENCE ON REDUCTION OF INCOME TAX COMPLEXITY I-J-1.

17. The problems in achieving a simplification constituency prompted Professor Bittker to observe that "simplicity is like a lighthouse: everyone can attest to its value, but no one will pay the price voluntarily." Bittker, *supra* note 2, at 11. Bernard Shapiro noted the following in this regard:

exacerbates the other obstacles presented by the legislative process.

First, the Budget Committees and public supporters of a balanced budget continually place political pressure on tax writing committees to meet strict revenue targets. Because of time constraints and overly ambitious revenue targets set by reconciliation resolutions, Ways and Means and Senate Finance Committee members deliberate at times in an atmosphere not conducive to sound policy decisions. These deliberations often focus more on how much revenue will be raised or lost by a particular proposal, rather than on the proposal's potential impact on tax policy or simplicity.[18] Even if a proposal will take a step toward simplification, it will be rejected if it will not result in a revenue increase. This problem is among the biggest contributors to complexity and the lack of consistency in making policy decisions.

Second, because raising taxes has become such a political tail to be pinned on an opponent, especially in presidential politics, tax writing committees tend to write tax bills that use a mismatch of loophole-closing devices called "cats and dogs" in order to meet the increasing revenue demands.[19] "Cats and dogs" tend to be small revenue raisers, esoteric to most voters.[20] It can take several of these revenue enhancers to meet revenue demands.[21] The result is more complexity, not less, with revenue raising bills becoming a grab bag of "no new taxes." This is not always bad, of course, but it tends to encourage more complexity. Another practice that has increased complexity in the Code is the increased use of transition rules.[22] American business planners require a degree of certainty as to the tax implications of their business decisions. With the Code being revisited with increasing frequency over the last 12 years, transition rules have often been used to achieve fairness by

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> If you asked the public whether they support tax simplification, the answer . . . would come back *yes*. But then, if you asked whether they would support the elimination of particular exclusions or deductions, coupled with rate reductions, in order to have simplification, I think the answer would be *no* . . . Thus when taxpayers say they support tax simplification, they really may mean this: "If simplification means that I pay less tax, I support it; but if simplification means that I would or may pay more in taxes, count me out."

Shapiro, *supra* note 16, at I-J-2; *see also* Deborah H. Schenk, *Simplification for Individual Taxpayer: Problems and Proposals*, 45 TAX L. REV. 121, 123 (1989).

18. *See* McLure, *supra* note 16, at 28. Ronald Pearlman, former Chief of Staff of the Joint Committee on Taxation, has noted that formal requests for revenue estimates by members of Congress rose from 150 in 1983 to 1290 in 1989, a clear indication of the increased emphasis on revenue considerations. Ronald A. Pearlman, *Comment on "Complexity in the Tax Legislative Process"*, 1990 Proceedings of the Invitational Conference on Reduction of Income Tax Complexity I-L-2 (available through Tax Management Education Institute).

19. *See* McLure, *supra* note 16, at 29.

20. These types of revenue enhancers often have not been perceived by the general taxpaying public as tax increases. *See* Shapiro, *supra* note 16, at I-J-32.

21. *Id.* McLure cites the following as an example of this approach: "The Deficit Reduction Act of 1984 . . . dealt with such matters as tax straddles, at-risk loss provisions, nonsimultaneous like-kind exchanges, related party transactions, premature accruals, prepaid expenses, availability of the [Investment Tax Credit] on property leased to tax-exempt institutions, golden parachutes, and distributions involving tiered partnerships." McLure, *supra* note 16, at 29.

22. "Transition rules are provisions that exempt income and expense related to commitments made under prior law from ordinary treatment under the new law." McLure, *supra* note 16, at 51.

assisting businesses faced with rule changes occurring in the middle of a business transaction. They also help alleviate the retroactive effect of a new provision that destroys a legitimate agreement based on the old rules.[23] Transition rules can in the best sense achieve fairness. In the worst sense, they can greatly complicate the Code.[24]

Fourth, we now play a new game on the Committee on Ways and Means. It may amaze tax practitioners that this should be a "new" idea to the Congress: If a member proposes a provision that costs money, that member must also propose a way to pay for it.[25] This increased demand for offsetting revenue sources, although a sound procedure, tends to create more complexity in the Code. Now, changes often are motivated by short-term revenue considerations to pay for a currently pressing political problem. Less emphasis is placed on determining the long-term effects of such changes.[26]

However, these various forces, especially the budget pressures mentioned above, also have positive aspects. The government simply cannot afford undisciplined spending programs or open-ended tax incentives. New programs need prudent financing mechanisms. For example, the Committee on Ways and Means led the fight in the 100th Congress to kill a long-term health care bill sponsored by the late Congressman Claude Pepper. Though the bill was laudable from a pure policy perspective, no one knew the ultimate cost of the bill, nor was there any proposal on how to pay for the bill's benefits.[27] Catastrophic health care, another issue of critical importance, was repealed — not because of the program's merits, but because so many Americans refused to pay for some of the benefits.[28] Despite the failure of the catastrophic

23. For a more detailed discussion, see *id.* at 51-52.

24. McLure cites the following examples of complexity involving transition rule enactments:

> [E]very time depreciation schedules are changed, it is necessary to create a distinction, according to whether assets were placed in service before or after the change. If indexation is adopted for capital gains, it will be necessary to value the entire capital stock as of the date indexation begins or to have some rule for the determination of the fraction of gain to tax in the case of assets held before introduction of indexing.

Id.

> 25. Title VIII of the Omnibus Budget Reconciliation Act of 1990 contained provisions that drastically altered the budget process that Congress had followed since passage of the Gramm-Rudman antideficit law in 1985. This legislation requires that bills containing revenue increases in entitlement or other mandatory spending or reducing revenues must be deficit-neutral. A bill would be considered out of order for floor consideration unless accompanied by offsetting entitlements or revenue increases.

Congressional Quarterly, Inc., *New Budget Process for Congress, President*, 1990 CONG. Q. ALMANAC 173-75.

26. For instance, there has been considerable dissatisfaction with the changes made by the Tax Reform Act of 1986 in the international taxation area. Many commentators have claimed that in its zeal to lower tax rates, the Congress looked to the international arena to raise some of the needed revenues and paid insufficient attention to the competitiveness implications of the Act's international provisions. *See infra* note 54 and accompanying text.

27. The House of Representatives voted down this legislation on June 8, 1988, when H. Res. 466, the rule that would have allowed consideration of the bill, H.R. 3436, was defeated. For a more detailed discussion, see Congressional Quarterly, Inc., *Long-term Care Bill Fails, But Issue Lives On*, 1988 CONG. Q. ALMANAC 293-95.

28. For a detailed analysis of the issues surrounding repeal of the 1988 Medicare Cata-

health care initiative, the debate represents legislative debates of the future. Proponents of new spending programs will have to also proffer ways to pay for them.

Before embarking on a discussion of a solution to curb complexity, an outside factor affecting the tax legislative process and, therefore, tax complexity, deserves mention: the growing influence of special interest groups. The "sunshine" reforms of the 1970s opened up much of the tax legislative process to the public.[29] Different sectors of the public, each with their own agenda, could better monitor Congressional policy development, and as the organization of special interest groups became more sophisticated, these different interests could more effectively achieve their tax goals.[30] While this development has had both a positive and negative impact[31] and has made for both good and bad tax policy, it has not encouraged simplicity in the Code.

It should be noted here that increased media scrutiny of tax legislation is having a considerable impact on the tax legislative process as well.[32] For instance, special tax breaks for single taxpayers, so-called "rifle shots,"[33] are now in disfavor after receiving much critical public attention.[34] The increased scrutiny has generally been a healthy development; with more public attention, legislators are more likely to think about overall tax policy objectives, such as tax simplification, rather than taking a rifle shot approach to the Code.

All of these factors that work against tax simplification are inherent in the legislative process and are with us whether we like them or not. Unfortunately, neither the politics nor the legislative process itself are likely going to change dramatically.[35] Even with this realization, the problem and its effects remain.

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strophic Coverage Act, see Congressional Quarterly, Inc., *Catastrophic-Coverage Law is Repealed*, 1989 CONG. Q. ALMANAC 149-56.

29. For a more detailed discussion of these government reforms, see Shapiro, *supra* note 16, at I-J-18.

30. *See generally* JEFFREY H. BIRNBAUM & ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987) (describing role of lobbyists in Tax Reform Act of 1986).

31. *See* Paul McDaniel, *Federal Income Tax Simplification: The Political Process*, 34 TAX L. REV. 27, 46-47 (1978) (discussing the impact of sunshine reforms on the tax legislative process).

32. For an interesting discussion of the growing influence of the media on the policy process, see DORIS A. GRABER, MASS MEDIA AND AMERICAN POLITICS (3d ed. 1989).

33. *See supra* notes 13-15 and accompanying text.

34. In 1988, the Philadelphia Inquirer published a series of articles on the use of so-called rifle shots in TRA '86. *See* Donald Bartlett & James Steele, *The Great Tax Giveaway*, PHILADELPHIA INQUIRER, Apr. 10-16, 1988, at A1. It should be noted that commentators have also described positive aspects of these provisions, including the low revenue costs of providing such relief in comparison to the use of generic transition rules. *See, e.g.*, Lawrence Zelenak, *Are Rifle Shot Transition Rules and Other Ad Hoc Tax Legislation Constitutional?*, 44 TAX L. REV. 563, 565-67 (1989); Pat Jones, *The Controversy Over Rifle Shot Transition Rules*, 39 TAX NOTES 543, 543-44 (1988).

35. One commentator noted the following in this regard: "It is unrealistic to call for tax simplification without recognizing that the goal must be achieved through the political process (which itself may be part of the problem), and without identifying the existence, strength and interests of the various factors operating within the process." McDaniel, *supra* note 31, at 30-31.

II. SUGGESTIONS TO ALLEVIATE THE COMPLEXITY

One unwise proposal to curb complexity would be raising revenue by raising rates,[36] instead of closing loopholes. Equally unwise would be doing nothing at all.[37] Much tax reform can be accomplished by changing the Code itself without raising rates; a rates-only approach could abrogate that debate. In addition, some observers argue that the budget process is the real culprit, and dealing with that issue first is necessary before attempting simplification. Although there is some merit to this argument, tackling the budget process, while doing nothing toward tax simplification, should be a last resort. Reform of the budget process and the Code must go hand-in-hand; otherwise, no effective changes will be sustained.

The most important step we could take budget-wise toward tax simplification — and it is a major one — is to consider a two-year budget cycle instead of a yearly reexamination of the budget.[38] A two-year budget cycle would greatly reduce the pressure of working under seriously constraining deadlines.[39] The tax writing committees could then concentrate in the "off" year on policy review and simplification matters. This change would also promote more constancy in the Code and thus allow for the development of a more stable economic policy.[40]

As previously noted, however, major changes are not likely to occur in the near future due to the institutional constraints of the Congress. Smaller, more achievable goals should remain our objective.[41] Examples include:

(1) Congress should instruct the Joint Committee on Taxation to take the point position on simplification.[42] Every legislative proposal should be assessed not only for its revenue impact and tax policy considerations, but also on how it impacts the complexity of the Code.[43] Congress should take

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36. For descriptions of the rates only approach to curb complexity, see McLure, *supra* note 16, at 87-89; Shapiro, *supra* note 16, at I-J-33.

37. *See* McLure, *supra* note 16, at 94-95.

38. Multi-year budgeting has long been suggested by commentators. *See, e.g.*, Karla W. Simon, *The Budget Process and the Tax Law*, 40 TAX NOTES 627, 642 (1988); *Reform of the Federal Budget Process, Hearings Before a Subcommittee of the House Committee on Government Operations*, 100th Cong., 1st Sess. 121, 136-38 (1987) (statement of Alice Rivlin, Director of Economic Program, Brookings Institution); Shapiro, *supra* note 16, at I-J-35.

39. Professor Simon observes that a two-year cycle "would reduce the annual scramble for new tax provisions designed to raise more revenue." Simon, *supra* note 38, at 642.

40. *See id.* at 643.

41. This section draws heavily from Shapiro, *supra* note 16, at I-J-31-41.

42. Section 8022 of the Internal Revenue Code authorizes the Joint Committee "[t]o investigate measures and methods for the simplification of such taxes, particularly the income tax; and . . . [t]o publish from time to time, for public examination and analysis, proposed measures and methods for the simplification of such taxes." 26 U.S.C. § 8022 (1986); *see* Shapiro, *supra* note 16, at I-J-36.

43. On April 16, 1993, the American Institute of Certified Public Accountants released its "Tax Simplification Index" as a guide to tax drafters to assess the relative complexity of proposed tax legislation. The Index is a list of fifteen objective multiple choice questions. Answer choices for each question are ranked by a score ranging from positive to negative. The fifteen scores are added up and divided by fifteen; the resulting score measures the degree of complexity. The higher the number, the greater the tax proposal's contribution of complexity to the Tax Code. The phrasing of each question also hints at ways to achieve simplicity. AICPA, TAX SIMPLIFICATION INDEX (1993).

the primary responsibility of simplifying the Tax Code because it carries the heaviest tax-writing burden.

(2) The chairperson and subcommittee chairpersons of the Committee on Ways and Means should insist on comments and debate concerning complexity from advocates of changes in the Code. During markups, members should focus on the complexity of proffered amendments as well as the cost and means of payment.[44]

(3) Congress should ask the Department of the Treasury and the Internal Revenue Service to comment and make recommendations on simplification at every opportunity.[45] This should occur both during the drafting of legislation and the markup of bills before the tax writing committees.

(4) A tax simplification task force should be established by Congress. The President should select its members. The task force should include tax-writing leaders in the Congress and the Executive branch as well as private sector tax practitioners and leaders in academia. The group should have maximum public exposure and time to develop not only specific recommendations, but also a reasonable timetable to help the Congress achieve these goals.

(5) Political leaders in both the executive and legislative branches must adhere to better schedules and operate in a more organized manner. They should scrupulously avoid last minute, late night agreements, recognizing that time constraints are the biggest enemy of tax simplification.[46]

III. SPECIFIC EXAMPLES OF COMPLEXITY

As mentioned earlier, these needed procedural changes should be coupled with the simplification of numerous areas of the Code. Most tax practitioners would agree on two areas that especially merit simplification: 1) the taxation of multinational corporations and 2) pension regulations.

A. TAXATION OF MULTINATIONAL CORPORATIONS

The marketplace for goods and services has become increasingly global in nature.[47] Foreign markets continue to grow and change, and foreign businesses continue to take advantage of these new opportunities.[48] It is imperative that U.S. companies adapt to this changing world market. In addition, U.S. tax policy must not impair the ability of these companies to compete

44. Shapiro concedes that simplification concerns would not necessarily rule the day in each instance. *See* Shapiro, *supra* note 16, at I-J-40. But the time honored adage "out of sight, out of mind" should be a reminder that simplification will likely occur more readily if the issue is formally structured into the tax legislative process.

45. *See id.* at I-J-37.

46. For example, Congressional consideration of Section 89 rules and regulations demonstrates the havoc that late night sessions can wreak on the Code.

47. *See generally* ROBERT G. REICH, THE WORK OF NATIONS (1991); *see also* William P. McClure & Herman B. Bouma, *The Taxation of Foreign Income From 1909 to 1989: How a Tilted Playing Field Developed*, 40 TAX NOTES 1379 (1989).

48. *See* McClure & Bouma, *supra* note 47, at 1380.

abroad.[49]

Our system of taxing U. S. multinational companies is perceived by many to be the most complex area of the Code.[50] This complexity generates serious and oppressive compliance burdens on U. S. multinationals, thereby hindering their ability to compete in the world marketplace.[51] This section focuses on two areas of international taxation that merit simplification, namely, the anti-deferral provisions of the Code[52] and the rules governing the translation of foreign income and taxes into U.S. dollar amounts.[53]

The United States imposes a tax on "U.S. citizens and residents and U.S. corporations (collectively, U.S. persons) on their worldwide income, subject to a credit against U.S. tax on foreign income based on foreign taxes paid with respect to such income."[54] Generally, the United States does not tax the earned income of a foreign corporation, which is owned in whole or in part by U.S. persons, until that income is distributed by the foreign corporation to its U.S. shareholders.[55] Thus, there is deferral of U.S. tax until repatriation.[56]

Congress has eliminated this tax deferral privilege in certain areas. At present, the Code contains the following anti-deferral regimes that require current inclusion of certain categories of income earned through a foreign corporation:

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49. As one commentator expressed it, "[t]here clearly is a challenge for U.S. companies to adapt to a changing world marketplace and U.S. tax policy should be consistent with the need of the country for greater productivity and competitiveness." Stanford G. Ross, *U.S. International Tax Policy: Where Are We? Where Should We Be Going?*, 40 TAX NOTES 331 (1990). Mr. Ross cites numerous works which address competitiveness concerns. *See, e.g.*, U.S. COMPETITIVENESS IN THE WORLD ECONOMY (Bruce R. Scott & George C. Lodge eds., 1985); COMPETITION IN GLOBAL INDUSTRIES (Michael E. Porter ed., 1986); INTERNATIONAL COMPETITIVENESS (A. Spence & H. Hazard eds. 1986); *see also*, REICH, *supra* note 47; C. BERGSTEN, AMERICA IN THE WORLD ECONOMY: A STRATEGY FOR THE 1990'S (Institute for International Economics 1988). McClure & Bouma emphasize that it is better for the U.S. that a profitable opportunity overseas "be taken by a U.S.-owned company rather than a foreign-owned company [because] U.S.-owned companies are more likely . . . to hire U.S. employees and to purchase their requirements from American suppliers, thereby creating U.S. jobs and profitable business for U.S. plants." McClure & Bouma, *supra* note 47, at 1380. The author wishes to emphasize that this argument should not mask the problem of U.S. multinationals expanding abroad "not to penetrate foreign markets but to produce for the U.S. market (the so-called runaway plant problem)." Ross, *supra*, at 332.

50. *See* David R. Tillinghast, *International Tax Simplification*, 8 AM. J. OF TAX POL'Y 187, 189 (1990); Charles E. McLure, *International Aspects of Tax Policy for the 21st Century*, 8 AM. J. OF TAX POL'Y 167 (1990).

51. For a detailed discussion of this problem, see Robert H. Aland, *Europe 1992: Tax Planning for U.S. Multinationals*, 1990 TAXES 1072; McClure & Bouma, *supra* note 47, at 1379-1409; Ross, *supra* note 49, at 331-32.

52. I.R.C. §§ 951-64, 551-58, 1291-97, 541-47, 531-37, 1246-47 (1988).

53. *Id.* § 986(a).

54. STAFF OF JOINT COMM. ON TAXATION, EXPLANATION OF "TAX SIMPLIFICATION ACT OF 1991", 102D CONG., 1ST SESS. 44 (1991) [hereinafter EXPLANATION]. For a more detailed discussion, see Hugh J. Ault & David F. Bradford, *Taxing International Income: An Analysis of the U.S. System and Its Economic Premises*, NBER WORKING PAPER NO. 3056 (National Bureau of Economic Research ed., 1989).

55. Ault & Bradford, *supra* note 54; *see* I.R.C. § 61(a)(7) (West 1992); Treas. Reg. § 1.301-1(b) (West 1993).

56. Ault & Bradford, *supra* note 54, at 28.

1. the controlled foreign corporation (CFC) rules,[57]
2. the passive foreign investment company (PFIC) rules,[58]
3. the foreign personal holding company (FPHC) rules,[59]
4. the personal holding company (PHC) rules,[60]
5. the foreign investment company (FIC)rules,[61] and
6. the accumulated earnings tax (ACE) rules.[62]

These anti-deferral regimes were enacted at different times to address different concerns.[63] They contain different thresholds for their application and different mechanisms for denying deferral.[64] Taxpayers who own stock in foreign corporations often must consult and comply with overlapping sets of anti-deferral rules, with the end result being increased administrative costs with little or no ultimate tax consequences.[65] To paraphrase one practitioner, statutory surgery is clearly needed.[66]

Chairman Rostenkowski's legislation[67] would provide meaningful simplification of the anti-deferral rules. Generally, the bill collapses the current anti-deferral regimes into two: the current Subpart F (CFC) rules[68] and a proposed Passive Foreign Corporation (PFC) regime that replaces the PFIC, the FIC, and the majority of the FPHC regimes.[69] This two-pronged approach eliminates many of the numerous definitions contained in the current anti-deferral provisions, thus relieving taxpayers of the need to refer to and comply with multiple sets of anti-deferral regimes containing separate defini-

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57. I.R.C. §§ 951-64 (1988). These provisions are commonly referred to as the "Subpart F" rules.
58. I.R.C. §§ 1291-97 (West 1993).
59. I.R.C. §§ 551-58 (1988).
60. *Id.* §§ 541-47.
61. *Id.* §§ 1246-47.
62. *Id.* §§ 531-37.
63. McClure and Bouma note that anti-deferral rules often were enacted to curb abuses of U.S. tax laws or simply to raise revenue. Overseas competitiveness and tax simplicity often takes a back seat to these concerns. *See* McClure & Bouma, *supra* note 47, at 1381; *see also* Ross, *supra* note 49, at 332-33.
64. *See* EXPLANATION, *supra* note 54, at 44.
65. *See id.* at 45.
66. *See* Tillinghast, *supra* note 50, at 199.
67. H.R. 2777, 102d Cong., 1st Sess. (1991).
68. The bill retains the Subpart F rules as the cornerstone of its unified anti-deferral regime, with certain modifications. *See* EXPLANATION, *supra* note 54, at 46. Chairman Rostenkowski has also introduced H.R. 5270, the Foreign Income Tax Rationalization and Simplification Act of 1992, which makes further substantive changes to the anti-deferral regime. H.R. 5270, 102d Cong., 2d Sess. (1992). While this bill was the subject of hearings by the Committee on Ways and Means on July 21st and 22nd, 1992, no further legislative action was taken on the bill in the 102d Congress.
69. *See* EXPLANATION, *supra* note 54, at 47; David R. Tillinghast et al., Foreign Provisions of the Proposed Tax Simplification Act 3 (July 29, 1991) (unpublished manuscript, on file with the *SMU Law Review*) [hereinafter Foreign Provisions]; under the proposed rules, a PFC is defined as follows:

> any foreign corporation if (1) 60 percent or more of its gross income is passive income, (2) 50 percent or more of its assets (on average during the year, measured by value) produce passive income or are held for the production of passive income, or (3) it is registered under the Investment Company Act of 1940 (as amended) either as a management company or as a unit investment trust.

EXPLANATION, *supra* note 54, at 47.

tions and requirements.[70] Under the new rules, it is possible to reduce to one the number of anti-deferral regimes that apply to a shareholder's interest in a foreign corporation.[71] Enactment of these anti-deferral regimes could reduce administrative and compliance costs considerably and provide U. S. multinationals with the opportunity to allocate their resources in ways that enhance their competitive positions in the world marketplace.

In addition, the Tax Reform Act of 1986 adopted a comprehensive set of rules concerning foreign currency, including provisions relating to translating foreign currency amounts into United States dollars.[72] United States taxpayers are required to establish a "functional currency" in which their income and expenses must be calculated.[73] A foreign corporation or branch may choose as its functional currency the currency in which it conducts its affairs and maintains its books.[74] If a foreign functional currency is used, then "the foreign currency amounts are translated into U.S. dollars at a prescribed appropriate exchange rate."[75]

However, for purposes of determining the foreign tax credit, foreign taxes paid are required to be translated into dollars at the exchange rate in effect on the date the taxes were paid.[76] This payment date translation rule has proved to be an administrative nightmare for U. S. multinationals.[77] Multinational corporations may make hundreds of separate tax payments to foreign countries each year. It is a major if not impossible task for taxpayers to carry out the record-keeping necessary to comply with these requirements.[78]

Section 321 of Chairman Rostenkowski's simplification bill would allow foreign tax payments to be translated into U.S. dollar amounts using an average U.S. dollar exchange rate for a specified period.[79] This rule would be a

70. *See id.* at 45-46.

71. *See id.* Tax practitioners have long recommended a two-pronged approach. *See, e.g.*, Tillinghast, *supra* note 50, at 192-203. Some commentators have constructively criticized the bill's anti-deferral provisions. *See* Foreign Provisions, *supra* note 69, at 3 (stating that the bill includes too many subrules and alternatives under second regime). The ABA's Taxation Section has suggested that the bill's PFC rules be inapplicable to CFC's, believing that CFC deferral issues are dealt with sufficiently by Subpart F. *See* American Bar Ass'n Section on Taxation, Committee on Foreign Activities of U.S. Taxpayers, *Comments on Title III—Foreign Provisions of H.R. 2777 and S. 1394, The Tax Simplification Act of 1991* (Nov. 1, 1991), *reprinted in* 1991 TAX NOTES 1481, 1499-1503 (Nov. 4, 1991) [hereinafter *ABA Comments*].

72. This discussion draws heavily on Tillinghast, *supra* note 50, at 239-41, and Ault & Bradford, *supra* note 54, at 15-16.

73. *See* Ault & Bradford, *supra* note 54, at 15.

74. *See id.*

75. Tillinghast, *supra* note 50, at 239; *see* I.R.C. § 989(b) (West 1993).

76. *See* I.R.C. § 986(a)(A) (West 1993).

77. For comments supporting this statement, see STAFF OF HOUSE COMM. ON WAYS AND MEANS, 101ST CONG., 2D SESS., WRITTEN PROPOSALS ON TAX SIMPLIFICATION 265 (Comm. Print 101-27, 1990) [hereinafter WRITTEN PROPOSALS]; Tillinghast, *supra* note 50, at 239.

78. "A taxpayer must commit substantial time and expense in order to track each day's exchange rate in each foreign currency, to match each tax payment with a daily exchange rate, to verify that the foreign tax receipt accurately reflects the payment date, and to collate this information to reach U.S. dollar amounts of foreign taxes." National Association of Manufacturers, The Foreign Income Tax Equity Act of 1991 (Jan. 1991) (unpublished manuscript, on file with the *SMU Law Review*).

79. *See* H.R. 2777, 102d Cong., 1st Sess. § 321 (1991); EXPLANATION, *supra* note 54, at 68.

clear improvement over the current method of translation. It would substantially reduce the current number of translation calculations.

Some commentators have argued that, although this approach is more favorable than current law, it still maintains the mismatch between foreign income tax translation and the functional currency rules that address the translation of every other item of a company's income and expenses.[80] These commentators advocate translating foreign taxes under a functional currency approach, whereby a foreign company would maintain foreign tax pools in its functional currency and would translate those taxes at the same exchange rate that it translates its earnings.[81]

B. EMPLOYER-SPONSORED RETIREMENT PLANS

The preferential tax treatment of private, employer-sponsored retirement plans should also be simplified.[82] Designed to promote retirement security, these rules are fast becoming a barrier. Simplification of these provisions would ensure that the nation's workforce will have sufficient resources to meet its retirement needs.[83]

Employers, especially small employers, find it difficult to comply with the complex laws governing pension plans for their employees. Since establishing or continuing a plan is voluntary, this complexity deters some employers from establishing pension plans and also causes others to terminate existing plans.[84] The reduction in the number of workers covered under employer sponsored plans forces the social security system and personal savings to take on more of the burden of replacing preretirement income.[85]

There are a number of important changes that could and should be made

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80. *See, e.g., ABA Comments, supra* note 71, at 1503; Foreign Provisions, *supra* note 69, at 13.

81. This solution is essentially a return to the "Bon Ami" approach. *See* The Bon Ami Co. v. Commissioner, 39 B.T.A. 825 (1939); *ABA Comments, supra* note 71, at 1503; Tillinghast, *supra* note 50, at 239-40; WRITTEN PROPOSALS, *supra* note 77, at 265 (remarks of American Petroleum Institute).

82. A pension plan that satisfies the qualification standards of The Code receives special tax treatment. Both the employer and the employee receive tax benefits from this special tax treatment. *See* STAFF OF JOINT COMM. ON TAXATION, COMPARATIVE DESCRIPTION OF PROPOSALS RELATING TO PENSION ACCESS AND SIMPLIFICATION (H.R. 2730, H.R. 2641, H.R. 2742, AND OTHER PROPOSALS), 102D CONG., 1ST SESS. 2 (July 24, 1991) [hereinafter DESCRIPTION]. These benefits result in a significant tax expenditure, projected to be $54 billion in fiscal year 1992. *See* STAFF OF JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 1992-1996, 102D CONG., 1ST SESS. (Mar. 11, 1991).

83. For an excellent, detailed analysis of causes and solutions to pension law complexity, see ASSOCIATION OF PRIVATE PENSION & WELFARE PLANS, GRIDLOCK: PENSION LAW IN CRISIS AND THE ROAD TO SIMPLIFICATION (1989) [hereinafter GRIDLOCK].

84. The IRS reported that the number of defined benefit plans terminated in Fiscal Year 1989 rose by thirty-seven percent. *See* Kevin Flatley, Statement of the Association of Private Pension and Welfare Plans on Pension Access and Simplification before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means 1 (July 25, 1991) (available through APPWP) [hereinafter APPWP Testimony]. Flatley cited further evidence of the urgent need for pension simplification. "In FY1990, there were more than seven times as many . . . plan terminations as new plans established . . . Perhaps even more troubling, is that in FY1990, for the first time, there was also a net negative growth of defined contribution plans (e.g. 401(k) and similar type plans)." *Id.*

85. *See* DESCRIPTION, *supra* note 82, at 2-3.

to the pension regulations that would not modify underlying tax policy, but would still allow that policy to be implemented more efficiently. Two examples merit discussion. First, 401(k) plans have proven to be a popular and meaningful vehicle for many companies, especially smaller and mid-sized firms, to extend retirement savings coverage to their employees. Regrettably, the current non-discrimination rules covering these plans, while well-intentioned, are enormously complex to administer and, worse yet, lead to unintended results.[86] For example, a plan may pass the non-discrimination tests one year, but fail the following year (despite the fact that the plan has not changed at all), only because some employees have chosen not to contribute as much or because the workforce composition has changed. This problem is especially pronounced among smaller firms when the decisions of just a few employees may spell the difference between passing and failing the non-discrimination test.

Another anomalous result is that people who just fall within the "highly compensated group"[87] may have their permitted contributions scaled back while someone earning just under this amount is not affected at all.[88] Finally, and most troubling, the correction mechanism under the rules[89] penalizes middle income workers, not the very highest earners who are deferring the greatest amount into the plan.[90]

One solution to these problems would be to establish a design-based safe harbor for 401(k) plans. If employers would be willing to match contributions for all of their employees at a generous level, then by its very design the plan would not be discriminatory and further non-discrimination testing could be avoided. Those employers unwilling to make such a commitment would have to abide by the current non-discrimination rules.

Section 4222 of The Tax Fairness and Economic Growth Act of 1992,[91] as passed by the House of Representatives, offers two such safe harbors.[92] For employees who make elective contributions to the plan, the employer must match 100 percent of the first 3 percent of payroll, and 50 percent of the next 2 percent of payroll contributed by the employee.[93] Alternatively, the em-

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86. *See* I.R.C. §§ 401(k)(3), 401(m) (West 1993).

87. *See id.* §§ 401(k)(5), 414(q).

88. See GRIDLOCK, *supra* note 83, at 23-24, for an example of this problem.

89. *See* I.R.C. § 401(m)(6) (West 1993).

90. The APPWP cites the following example of this problem:

> In a typical situation, if a store manager earning $50,000 contributes $7000, her deferral percentage will be 14 percent. If the firm president contributes $7000 and earns $200,000, his deferral percentage is 3.50 percent. If the [Actual Deferral Percentage] tests are not met, the store manager's deferral must be reduced first, because of her higher deferral ratio, even though her contribution was the same as the president's.

GRIDLOCK, *supra* note 83, at 24.

91. H.R. 4210, 102d Cong., 2d Sess. (1992). Former President Bush vetoed this bill on March 20, 1992.

92. This section of H.R. 4210 was reintroduced in H.R. 13, Section 233, 103d Cong., 1st Sess. (1993).

93. *See* STAFF OF HOUSE COMM. ON WAYS AND MEANS, 102D CONG., 2D SESS., TECHNICAL EXPLANATION OF H.R. 4287, TAX FAIRNESS AND ECONOMIC GROWTH ACT OF 1992 111-14 (Comm. Print 1992).

ployer could choose to make nonelective contributions of 3 percent of payroll on behalf of all employees.[94] Under this proposal, an employer will know at the start of each year whether the plan satisfies the nondiscrimination requirements. The proposal provides needed certainty and eliminates a significant administrative burden that often acts as a deterrent to the establishment of such plans. This provision was also included in H.R. 11, The Revenue Act of 1992.[95]

A second area in need of simplification concerns the requirement under Code Section 410(b) that union and non-union workers who happen to be in the same plan must be "disaggregated" for purposes of testing whether the plan meets certain coverage tests. This rule makes no sense and seemingly has no purpose since it artificially requires the separation of different workers who are covered under the same plan and are receiving identical benefits.[96] Worse yet, mandatory disaggregation could produce the undesirable result of forcing employers to establish separate and less generous benefits for collectively-bargained rank and file workers.[97]

If employers are willing to include collectively-bargained workers in the same retirement plan being extended to non-collectively-bargained workers, the company should not have to separate the workers for testing purposes. Aggregation of these workers would simplify the Code and enjoy the support of labor and management alike.[98]

CONCLUSION

Despite the high hurdles and intimidating obstacles, tax simplification is worth the effort. The integrity of the Code and compliance with the Code are directly affected by its understandability. One thing is certain: Congress can — and should — do a better job of simplifying the Code.

94. *See id.*

95. H.R. 11, 102d Cong., 1st Sess. (1991). This provision is also part of H.R. 13, The Tax Simplification Act of 1993.

96. Disaggregation often causes plans to fail the coverage and nondiscrimination tests even though the separated workers receive identical benefits. *See* APPWP Testimony, *supra* note 84, at 7.

97. *See id.*

98. H.R. 2641, introduced by Congressman Rod Chandler, addresses this problem by providing employers with the option to aggregate union and nonunion employees covered under the same plan on the same terms for the purposes of the minimum coverage rules, the nondiscrimination rules, and the separate line of business rules. *See* DESCRIPTION, *supra* note 82, at 39. Unfortunately, this provision was not incorporated into the Tax Fairness and Economic Growth Act of 1992.