Guiding Principles for Tax Simplification

Issued by the Tax Division of the
American Institute of Certified Public Accountants
NOTICE TO READERS

Tax Policy Concept Statements of the AICPA Tax Division are issued for the general information of those interested in the subject. They present the conclusions of the division, as approved by the Tax Executive Committee. The Tax Executive Committee is the senior technical body of the AICPA authorized to speak for the AICPA in the area of federal income taxation.

Tax Policy Concept Statements are intended to aid in the development of federal tax legislation in directions that the AICPA believes are in the public interest.

Tax Policy Concept Statements do not establish standards enforceable under the AICPA’s Code of Professional Ethics and are not intended for that purpose.
FOREWORD

This is the second in a series of Tax Policy Concept Statements issued by the AICPA Tax Division. It is intended to aid in the development of federal tax legislation in directions that the AICPA believes are in the public interest.

Tax Policy Concept Statements are approved by the Tax Executive Committee of the AICPA Tax Division after they are developed and approved by the division’s Tax Legislation and Policy Committee. Other division committees and technical resource panels may develop Tax Policy Concept Statements if requested to do so.

This Statement was developed by the Tax Simplification Task Force with input from the 2000–01 and 2001–02 Tax Legislation and Policy Committees. It was approved by the 2001–02 Tax Legislation and Policy Committee and the 2001–02 Tax Executive Committee. Members of the bodies that approved this Tax Policy Concept Statement are listed below.

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The AICPA Tax Division gratefully acknowledges the significant contributions of Judyth A. Swingen in the development of the direction and the drafting of the Statement.
Guiding Principles for Tax Simplification

IMPORTANCE OF TAX SIMPLIFICATION

The U.S. tax system, as well as tax systems in most states, is based on the fundamental concept of self-assessment. The efficiency and effectiveness of this approach largely depends on the ability and willingness of taxpayers to understand and comply with their legal obligations, as well as the ability of tax administrators to interpret and equitably enforce an extensive body of tax law.

In recent years, the complex nature of tax laws has undermined voluntary compliance by eroding public perceptions of tax fairness and imposing inappropriate compliance burdens. Federal and state tax agencies have difficulty providing accurate assistance to taxpayers, designing understandable forms and instructions, and promulgating timely regulatory guidance. Tax advisers spend considerable time assisting clients with compliance problems, when that time would be better spent on value-added activities, such as personal financial or strategic business planning.

Many tax professionals believe that significant simplification is needed to ensure the continued viability of our self-assessment approach. If tax laws continue to become increasingly complex, potential impacts include the following:

- Lower levels of voluntary compliance
- Inadvertent tax overpayments or deficiencies
- Increased perceptions that the tax system is unfair
- Higher costs for both tax administration and tax compliance
- Poorer quality of tax administration and tax assistance
- Inefficient economic decisions, driven primarily by tax considerations
- Unintended tax “traps” for certain taxpayers

AICPA TAX SIMPLIFICATION ACTIVITIES

The AICPA has long understood the consequences of tax law complexity and has supported efforts to move toward a simpler tax system. In 1992, the AICPA Tax Division published *The Blueprint for Tax Simplification* and identified a need for the following:

- A visible and vocal constituency to communicate the need for tax simplification
- A set of principles to guide the design of a simpler tax system
- An understanding of the factors that contribute to complexity
- A thorough consideration of the need for simplification at all stages of the legislative and regulatory process
- A meaningful method for routinely analyzing or scoring proposed legislation and regulations to assess the impact on complexity/simplification
Over the last decade, the AICPA has drafted proposals for tax law simplification, developed an index for assessing the complexity of proposed rules, testified before Congress concerning the potential complexities of pending provisions, and worked with other professional organizations to support simplification efforts.

In 2001, the AICPA Tax Division published Tax Policy Concept Statement No. 1, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*. The Statement identifies simplicity as one of the 10 attributes of a good tax system and states, “The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.”

Complexity also inherently undermines attempts to achieve many of the other attributes of a good tax system identified in Concept Statement No. 1:

- **Equity and fairness**: Complexity contributes to public perceptions that the tax law is unfair.
- **Certainty**: Complexity due to constant change and lags in administrative guidance heighten taxpayer uncertainty.
- **Economy of collection**: Complexity increases the costs of tax administration, including the costs associated with collecting taxes, examining returns, and resolving disputes.
- **Neutrality**: Complexity may cause similarly-situated taxpayers to pay different amounts of tax.
- **Economic growth and efficiency**: Complexity diverts resources from productive activities and investments to excessive and nonproductive compliance costs.
- **Transparency and visibility**: Complexity leaves taxpayers perplexed about how the tax law applies to them and others.
- **Minimum tax gap**: Complexity increases the size of the tax gap by making taxpayers less willing and able to comply. The tax gap is the difference between taxes that are owed and taxes that are voluntarily paid.

**AICPA TAX POLICY STATEMENT**

In this document, Tax Policy Concept Statement No. 2, *Guiding Principles for Tax Simplification*, the AICPA reaffirms its support of efforts to reduce complexity in existing federal and state tax laws and to curtail incremental complexity in the future. Although an absolutely simple tax system may not be feasible in today’s complex business and economic environment, a relatively simpler system is possible. Further, a simpler tax system will benefit individual taxpayers, businesses, federal and state tax agencies, and the economy.

**THE GUIDING PRINCIPLES FOR TAX SIMPLIFICATION**

The AICPA recommends that the following guiding principles be used in the development of simpler tax legislation and regulations:
• **Make simplification a priority.** Simplification must be viewed as a priority tax policy objective and given substantial consideration in conjunction with the development of legislation and administrative guidance.

• **Seek simplest approaches.** Once tax lawmakers identify desired tax policy or revenue objectives, the simplest and most transparent approaches to implementation should be sought.

• **Minimize compliance burdens.** Compliance costs, in terms of both time and money, should be minimized and should be commensurate with the resources and abilities of the affected taxpayers.

• **Reduce frequency of tax law change.** Change in and of itself increases complexity in the short run, even if the change will produce long-term simplification. Tax laws should be changed only to address changes in revenue needs, to implement significant changes in tax policy, or to alleviate existing complexities and inconsistencies.

• **Use consistent concepts and definitions.** Inconsistencies in legal concepts and definitions should be eliminated in existing law and avoided in the drafting of new laws.

• **Consider administrative burdens.** The ability of tax agencies to administer, provide guidance on, and enforce the law must be considered in the development of legislation and administrative guidance.

• **Avoid limited applicability.** Tax rules that apply to a limited set of taxpayers or for only a short period of time should be avoided.

A more detailed explanation and rationale for each of these guiding principles follow.

**EXPLANATION OF THE GUIDING PRINCIPLES FOR TAX SIMPLIFICATION**

**Make Simplification a Priority**

Tax simplification will benefit individual taxpayers, businesses, federal and state tax agencies, and the economy. Many politicians and tax administrators now cite simplification as a justification when they initially propose changes to tax laws. Then, as these proposals proceed through the legislative or regulatory process, budget considerations, political agendas, and other policy objectives take precedence over the need for simplification. The resulting tax law changes often increase, rather than reduce, complexity.

Congress and the Treasury must view tax simplification as a priority tax policy objective when developing legislation and administrative guidance. Complexity is often overlooked in drafting legislation because negative impacts on the tax system are often less obvious to lawmakers trying to solve “today’s” problems and only become apparent in the long-term. The cumulative effect of undue complexity is highly detrimental and should be addressed now, before the system fails to serve our nation’s revenue needs.

For lawmakers to seek simpler approaches, legislators must better understand why the current law is difficult—from both an administrative and compliance perspective. They must also believe that a simpler tax law is possible. Although some may view tax complexity as an
insurmountable problem, incremental steps toward simplification could help reduce complexity for many taxpayers.

**Seek Simplest Approaches**

At both the federal and state level, legislators cite various social and economic objectives as the justification for tax law changes. Budget considerations then constrain the timing and extent of these changes. Once lawmakers identify desired tax policy and revenue objectives, the simplest and most transparent approaches to implementation should be sought.

Complex or multistep calculations should not be required. Likewise, multiple provisions to achieve essentially the same or similar objectives should be avoided. Alternative choices between deductions and credits that require taxpayers to make multiple calculations to determine which yields the greatest tax benefit should be kept to a minimum. Tax recordkeeping should closely emulate normal business practices. The language used in definitions, explanations, and eligibility requirements should be understandable by the target group of taxpayers. In certain instances, safe harbors or *de minimis* rules should be considered as the simplest approach.

One potential consequence of seeking the simplest approach may be reduced precision. Under current law, simple general rules are often followed by definitions of specific terms used, as well as exceptions to the general rule and limitations. This is deemed necessary to anticipate all possible scenarios and close potential loopholes. Unfortunately, this level of detail tends to introduce significant complexity. Although simpler and less precise approaches may raise or lower taxes for an unintended few, less detail would simplify the tax law and reduce administrative and compliance burdens for many.

**Minimize Compliance Burdens**

One measure of the U.S. tax system’s complexity is the burden it imposes on taxpayers. Individual taxpayers and businesses are increasingly spending more time preparing tax-related forms and records. An increasing number of taxpayers are incurring costs for tax guidebooks, tax preparation software, and tax return preparation. Uncertainties and an inability to understand the tax laws cause anxiety and frustration for many taxpayers.

Compliance costs, in terms of both time and money, should be minimized for all taxpayers. Compliance costs also need to be commensurate with the abilities, business sophistication, and resources of the affected taxpayers. Higher compliance costs may be appropriate for complex business and investment transactions, but not for small businesses and middle-income taxpayers. Likewise, special provisions targeted to low-income taxpayers and the elderly should not be so complicated and confusing that these individuals must pay for tax return assistance to benefit.

Current methodologies for assessing compliance burdens, such as the time estimates for various tax forms and schedules, are flawed and outdated. Although better measures are needed to understand fully the magnitude of the problem, it is already clear that taxpayers expend excessive time and resources on compliance. Meaningful simplification would redirect these resources to more constructive and productive endeavors and promote economic growth.
Reduce Frequency of Tax Law Change

Change, in and of itself, increases complexity in the short run, even if the change will result in long-term simplification. With each change, tax administrators need time to redesign forms and instructions. Taxpayers and their tax advisers must study the changes and evaluate their potential applicability and impacts. Tax changes may also necessitate changes in already planned transactions, business and recordkeeping practices, and even entity structures.

In recent years, the tax law has been in a constant state of flux. As a result, there are higher levels of taxpayer confusion and frustration; tax forms and instructions are unduly complex; regulatory projects are backlogged; and technical corrections for legislative errors and omissions are frequently needed. Although a static tax law is neither likely nor desirable, Congress and the Treasury must reduce the frequency and extent of tax law changes. In addition, when new laws are proposed, more attention should be given to evaluating the impact of the changes. What are the economic impacts of the proposals? How do the changes affect taxpayer compliance burdens? Will these changes reduce or increase complexity in the long run?

Use Consistent Concepts and Definitions

A number of general concepts provide the foundation for federal and state tax laws. These concepts help determine who is subject to the tax, what is included in the tax base, and when the tax will be imposed. As long as these concepts are applied consistently among taxpayers and over time, taxpayers can readily estimate their tax liabilities with some degree of certainty. When tax laws are constantly changing and little care is taken to ensure that new definitions and rules are consistent with existing laws, confusion and perceptions of inequity abound.

The Internal Revenue Code and regulations define many terms and phrases. These definitions tend to be more limiting or narrow than the everyday meanings of those terms or phrases. Furthermore, there are multiple definitions for certain terms, such as dependent or related party, found in different sections of the law. This leads to considerable confusion.

As new law is drafted, lawmakers should strive for consistency in both concepts and definitions. There should also be a concerted effort to eliminate inconsistencies in existing law.

Consider Administrative Burdens

Tax administration is an essential element in the efficient functioning of a self-assessment system. Federal and state tax agencies must design forms and instructions, provide assistance and timely guidance to taxpayers, process massive amounts of data received from taxpayers and third parties, detect noncompliance, and enforce the laws. When tax law changes are complex, frequent, or enacted late in the year, the ability of tax agencies to administer the law is seriously compromised. The inability of the tax agencies to provide complete, prompt, and correct advice and guidance contributes to complexity and ambiguity.
As potential changes in the tax law are discussed, the implications for tax administration must be considered. Is there adequate time between the enactment and effective dates to modify forms, instructions, publications, and computer software? What will be the costs of making these changes and enforcing the new law? Will the number of taxpayers or volume of returns or forms to be processed change? Are the needed systems available or readily adaptable to enable the tax agencies to administer and enforce the new provisions?

For many taxpayers, tax forms and instructions are their only source of information about tax law. These publications are often criticized as a cause of tax law complexity and confusion. Unfortunately, it will be difficult to produce user-friendly tax forms as long as the underlying law is complex. As legislators debate tax law changes, they should explicitly address how the change will affect the design of forms. Will new forms or lines on forms be needed? Can the new rules be explained to taxpayers in simple language? What types of calculations and records will be required?

Avoid Limited Applicability

Tax law changes that apply to few taxpayers, or for only a short period of time, will have the same impact on tax law complexity as a change intended to apply to a broader set of taxpayers or for an extended period of time. With each change, tax administrators need to develop or revise tax forms and instructions. They may also need to issue regulatory guidance or to provide special assistance to the targeted group of taxpayers. Unless the rules clearly define who is eligible for (or subject to) the new rules, many taxpayers and their tax advisers will review the new rules, only to determine that they do not apply to them personally or to their businesses. Then, when this change expires in a few years, the whole process often starts over when legislators enact or extend deductions or credits designed to provide tax benefits to targeted groups or to encourage certain economic behaviors.

Other persistent sources of complexity are changes that are phased in over several years or have delayed effective dates. This is tantamount to having a new tax regime each year during the phase-in period, effectively increasing the frequency of change. With a major change, transition rules may be needed to ease unintended economic consequences. However, the phase-in rules enacted in recent years now seem to be solely a function of revenue estimates, not of transitional relief. A prolonged phase-in or “sun-setting” of new rules, as well as the potential sunset of an entire tax bill, increases complexity and uncertainty in tax administration, tax compliance, and tax planning.

CHALLENGES

Efforts to simplify federal and state tax laws face several challenges. Although the primary function of a tax system should be to generate necessary revenues, tax systems are also used to achieve an array of economic, social, and political goals. A visible and vocal constituency is needed to advocate the cause of tax simplification. Legislators and regulators must hear the message that (1) tax simplification must be a priority tax policy objective and (2) real simplification can also have economic, social, and political benefits. Lawmakers should also see
complexity as a primary factor behind the many complaints they receive about complicated forms, high costs of compliance, and frustrating experiences with tax agencies.

Tax lawmakers need to understand the factors that create and perpetuate complexity. As legislation and administrative guidance is drafted, legislators and regulators should seek the simplest approaches, minimize both compliance and administrative burdens, avoid inconsistent concepts and definitions, and avoid enacting provisions that apply to only a few or for only a short period of time.

Finally, the tax law-making process must be more deliberate. Frequent changes seldom allow adequate time to consider the big issues. Do these changes actually achieve the intended policy objectives? What do these changes do to the viability of our self-assessment system? Frequent changes with little or no consideration of the need for real simplification can be only detrimental.
APPENDIX
EXAMPLES OF COMPLEXITY

As part of its continuing efforts in support of tax law simplification, the AICPA has testified before Congress in recent years concerning tax provisions that are excessively complex. The following tables include a few of the provisions as of December 2001 that continue to pose complexity problems for many taxpayers, particularly individuals and smaller businesses. In the following tables, a “thumbs down” has been marked in cells to indicate the particular guiding principles that were violated when each of these complex provisions was initially enacted or amended.
Table 1. Individual and Family-Related Provisions

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<thead>
<tr>
<th>Guiding Principles&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Earned Income Tax Credit&lt;sup&gt;2&lt;/sup&gt;</th>
<th>Family &amp; Dependent Definitions&lt;sup&gt;3&lt;/sup&gt;</th>
<th>Child Credit&lt;sup&gt;4&lt;/sup&gt;</th>
<th>Education Incentives&lt;sup&gt;5&lt;/sup&gt;</th>
<th>“Kiddie Tax”&lt;sup&gt;6&lt;/sup&gt;</th>
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1 A “thumbs down” (✖) has been marked in cells to indicate particular guiding principles that were violated when each of these complex provisions was initially enacted or amended.
2 The earned income tax credit (EITC) benefits working taxpayers with lower levels of income. The rules for computing the EITC have changed virtually every year for the last several years. Taxpayers claiming this credit must deal with complex rules to determine eligibility, make numerous and confusing calculations, and often have to pay for assistance to complete their return.
3 Family status determines whether a taxpayer qualifies for various deductions and credits. It also determines applicable tax rates. Although the question of who is a family member seems relatively simple, the tax law makes the question complex by using inconsistent definitions for key terms, such as dependent and qualified child.
4 The child credit is one of the many tax provisions subject to income phase-out rules. As a result of legislation enacted in 2001, there will be frequent changes to this credit over the next several years. Generally, the credit is nonrefundable, but parents with three or more children can treat a portion of their credit as refundable. The procedure for determining the refundable portion is particularly complex and confusing. The child credit is just one of the many “family friendly” provisions enacted by Congress in recent years. It is also an example of the use of multiple provisions to achieve the same tax goal, that is, to provide parents with a tax reduction to cover the basic costs of raising children.
5 There are numerous tax provisions relating to the costs of higher education. These now include (1) deductions for educational expenses and student loan interest, (2) two different and mutually exclusive tax credits, (3) exclusion rules for employer-provided educational assistance and scholarships, and (4) special incentives for education savings plans. Many of these provisions are interrelated, but the definitions of eligible parties and expenses are not always consistent.
6 Due to the “kiddie tax” rules, children under the age of 14 pay tax on certain income at rates equivalent to their parents’ rates. The kiddie tax was intended to close a perceived tax loophole, that is, the shifting of income-producing assets to family members in lower marginal tax brackets. Although the kiddie tax has been relatively successful at achieving this objective, it has also added considerable complexity.
### Table 2. Business and Investment Provisions

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<tr>
<th>Guiding Principles</th>
<th>Corporate Alternative Minimum Tax</th>
<th>Worker Classification</th>
<th>Capital Gains &amp; Losses</th>
<th>Capitalization, Expensing &amp; Cost Recovery</th>
<th>Estimated Tax Safe Harbors</th>
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1. A “thumbs down” (♀) has been marked in cells to indicate particular guiding principles that were violated when each of these complex provisions was initially enacted or amended.
2. The corporate alternative minimum tax (AMT) imposes redundant recordkeeping requirements. Depreciation, the basis of various assets, and the gain or loss on assets sales and exchanges must be computed at least two different ways for tax purposes. Multinational corporations eligible for the foreign tax credit (FTC) must also compute different FTC limits for both the regular tax and the AMT.
3. Workers are classified as either employees or independent contractors. This classification has implications for income and Social Security taxes, as well as the Employees Retirement Income Security Act of 1974. Currently, a 20-factor common law test is used to make this classification.
4. The rules pertaining to capital gain and loss constitute a large portion of the Internal Revenue Code. These rules include several asset classification definitions and multiple netting procedures. If there is a net loss, limits and carryover rules apply. If there is a net gain, individual taxpayers then have to determine which of the ever-increasing list of preferential tax rates apply to their particular situation.
5. Since the Supreme Court’s 1992 INDOPCO decision, there has been considerable confusion concerning which expenditures businesses should expense or capitalize. The IRS reports that capitalization issues are a major cause of controversy for business taxpayers and a frequently litigated issue. Clear rules in this area would reduce both compliance burdens and administrative costs.
6. The income tax system is based on the pay-as-you-go concept. As a result, corporations and individuals with income not subject to withholding must make periodic estimated tax payments. Failure to comply leads to penalties. Taxpayers can avoid penalties by meeting safe harbors that are expressed as a percentage of the current or prior year’s tax obligations. In recent years these safe harbor rules have changed frequently, causing considerable confusion.
Table 3. Miscellaneous and International Provisions

<table>
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<tr>
<th>Guiding Principles</th>
<th>Individual Alternative Minimum Tax</th>
<th>Half-Year Requirements</th>
<th>Attribution Rules</th>
<th>Subpart F Rules</th>
<th>Foreign Tax Credit</th>
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1 A “thumbs down” ( &) has been marked in cells to indicate particular guiding principles that were violated when each of these complex provisions was initially enacted or amended.
2 The individual alternative minimum tax (AMT) imposes significant compliance and administrative burdens. It no longer fulfills the purpose for which it was enacted, that is, to ensure that persons with significant economic income do not escape paying tax due to investments in tax shelters. The individual AMT also has many unintended impacts due to its interaction with many credit provisions.
3 The pension and retirement savings rules include age 59½ as the earliest date for beginning distributions and 70½ as the latest date that distributions must start to avoid penalties. Full-year age thresholds would be simpler for taxpayers to understand and for tax and plan administrators to monitor.
4 Under the attribution rules, certain business interests owned by one taxpayer will be treated as indirectly owned by another taxpayer. The various attribution provisions found throughout the Internal Revenue Code contain similar, but subtly different, rules about when and by whom attributions must be made. This is a prime example of failure to follow consistent definitions and concepts.
5 A U.S. shareholder who owns 10 percent or more of a controlled foreign corporation must include a proportionate share of the foreign corporation’s income in his or her taxable income. To compute the includable amount, the U.S. shareholder must determine the source of various types of income, allocate expenses between countries, and understand a myriad of exceptions. The process is further complicated because the data needed is not always readily accessible, amounts may be denominated in another currency, and amounts are generally determined in accordance with the accounting and tax rules of the foreign country. The Subpart F rules impose significant compliance burdens, and it is questionable whether these can be effectively administered.
6 The function of the foreign tax credit is to mitigate multiple taxation, that is, when the same income is taxed by the United States and by one or more foreign jurisdictions. A major issue is which foreign taxes are creditable. Tax systems in other parts of the world differ considerably from the U.S. income tax system. Further, taxes paid in other countries may, or may not, be deemed paid by the U.S. taxpayer, depending on various attribution rules and the Subpart F rules. The credit is subject to further limits to prevent foreign taxes paid from disproportionately reducing the U.S. tax obligation. These limits must be computed for several different categories of income and, if the taxpayer is subject to the AMT, under both the regular and minimum tax rules.
BIBLIOGRAPHY


