# Tax Complexity, History and Humor

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*On March 25th, Jeff Scroggin provided LISI readers a 50 page analysis of where the estate planning profession is going, including 30 reasons why estate planning will be an area of growth for the next 30-50 years. Now Jeff provides LISI readers an analysis of the Code's complexity, offers some interesting aspects of tax history and provides a few perspectives on the humorous side of taxation.*

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## EXECUTIVE SUMMARY:

April 15th seemed an appropriate day to publish a commentary on the complexity, history and humor of our state and federal tax laws. April 1st might have been a more appropriate date, but some of this stuff just seems to be a bad joke.

Let's start with the great quote in 1947 from the renowned Federal Judge Learned Hand: "*In my own case the words of such an act as the Income Tax... merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer [me] no handle to seize hold of [and that] leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help ... wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness*."

There may be a rather universal feeling about the Tax Code among federal judges. Supreme Court Justice Harry Blackmun noted: "*If [a United States Supreme Court Justice is] in the doghouse with the Chief [Justice], he gets the crud. He gets the tax cases*."

# COMMENT:

In 2007 USA Today provided five tax preparers with a set of facts and asked each of them to prepare an income tax return. The five preparers produced five different tax results and could not agree among themselves on which result was correct.

From 1987 to 1998, Money magazine conducted an annual study in which it submitted facts to a group of tax return preparers. In Money's 1998 report, forty-six tax return preparers had forty-six different tax results, with the tax liability ranging from $34,240 to $68,912. This was the 7th time that Money noted that none of the tax return preparers came to the same conclusion.

In an April 4, 2006 report, the Government Accountability Office noted that it submitted tax preparation information to nineteen commercial tax preparers around the US to determine how accurate their work was. Every one of the completed returns contained errors and some overlooked common deductions.

But is it not just the tax preparers who are confused. In 2002, the IRS reported that 28% of the answers given by its call centers were wrong, 12% were incomplete and 12% of the time taxpayers' questions were not answered and taxpayers were told to do their own research.

If the tax professionals don't know how to handle the complexity of our tax laws, what hope does the average taxpayer have?

**The Political Dynamics**. Presidents love to complain about the complexity of the Tax Code, but most seem to add to its complexity once in office. President Obama in his 2013 State of the Union speech said *"The American people deserve a tax code that helps small businesses spend less time filling out complicated forms, and more time expanding and hiring—a tax code that ensures billionaires with high-powered accountants can't work the system and pay a lower rate than their hardworking secretaries; a tax code that lowers incentives to move jobs overseas, and lowers tax rates for businesses and manufacturers that are creating jobs right here in the United States of America."*

As noted by Bob Keebler and Peter Melcher in "*The New 3.8% Surtax and Trusts & Estates*," LISI Income Tax Planning Newsletter #40 (March 21, 2013) the ObamaCare tax is adding new tax uncertainties and complexities to tax planning for estates and trusts - to say nothing of the complexity and cost added to businesses. If adopted, the President's 2014 budget proposals would create even greater complexity to the federal tax system.

Just don't hold your breath waiting for simplicity. Other national leaders have been saying similar things for years:

- *"It is time for a complete overhaul of our income tax system... it is a disgrace to the human race."* Jimmy Carter, accepting the Democratic Nomination in 1976.

- *"[The federal government] should have a tax system which looks like someone designed it on purpose"* William E. Simon, former Treasury Secretary during the Nixon administration (1981).
- "*And I'm the one who will not raise taxes. My opponent now says he'll raise them as a last resort, or a third resort. But when a politician talks like that, you know that's one resort he'll be checking into. My opponent won't rule out raising taxes. But I will. And the Congress will push me to raise taxes and I'll say no. And they'll push, and I'll say no, and they'll push again, and I'll say, to them, 'Read my lips: no new taxes!'*" George H.W. Bush, accepting the Republican Nomination in 1988.
- The first annual report by the Taxpayer Advocate in 1997 (as required by the Taxpayer Bill of Rights II) listed the complexity of the federal tax law as *"The single most burdensome aspect of compliance for most taxpayers."* The Tax Code has only become more complex since 1997. A variation of the 1997 complexity statement has been made in each Taxpayer Advocate report since 1997.
- In April 2001 Congress's Joint Committee on Taxation issued a 1,292 page, 5 pound report on how to simplify the Federal Tax Code. In November 2005, the President's Advisory Panel on Federal Tax Reform reported on how the Tax Code could be simplified. The only real use of both reports seems to be as great bookends in many Congressional offices.
- *"Another drag on our economy is the current tax code, which is a complicated mess, filled with special interest loopholes, saddling our people with more than 6 billion hours of paperwork and headache every year*." George W. Bush, accepting the Republican Nomination in 2004.
- "*Complexity now causes $1 in Compliance Costs for each $7 in Federal Revenue Raised*." Ways and Mean Chairman (Republican) William Thomas (2005).
- "*The widely recognized complexity of the tax results in (1) significant compliance costs, frustration, and anxiety for taxpayers; (2) decreased voluntary compliance; (3) increased difficulties for the Internal Revenue Service (IRS) in administering the tax laws; and (4) reduced confidence in the fairness of the tax. The tax also causes taxpayers to change their work, savings, investment, and consumption behavior in ways that reduce economic efficiency and, thereby, taxpayers' well-being*." Statement to Congress by David M. Walker, Comptroller General of the United States (August 3, 2006).
- *The [tax] code today encompasses 9,500 pages of very small print. While every word…has some justification, in its entirety it is an abomination"* Paul O'Neal, former Treasury Secretary during the George W. Bush administration (2008).
- The December 2010 Simpson Bowles Report of the National Commission on Fiscal Responsibility and Reform said: *"The tax code is rife with inefficiencies, loopholes, incentives, tax earmarks, and baffling complexity. We need to lower tax rates, broaden the base, simplify the tax code, and bring down the deficit."* Both political parties pretty much ignored the report.

- "*... making the tax code less complex is the single most important thing that could be done to improve taxpayer service and boost compliance*." IRS Commissioner Douglas H. Shulman's testimony to Congress (2011).

**Tax Complexity.** Complexity is added to the tax laws in a number of ways, including (but certainly not limited) to:

The Sheer Volume of the Rules. CCH reported in 2012 that there are 73,608 pages of federal tax rules. According to the IRS Taxpayer Advocate Service ("TAS") in its 2012 report (issued on January 9, 2013): *"The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the code conducted using the "word count" feature in Microsoft Word turned up nearly 4.0 million words."* That's a rather significant departure from the 1913 federal income tax code which only contained 14 pages.

The growth of the federal tax laws was shown in a report by the Tax Foundation on the number of words in the tax rules (reported in the thousands):

| | 1955 | 1965 | 1975 | 1985 | 1995 | 2005 | Increase in 50 years |
|---|---|---|---|---|---|---|---|
| Entire Tax Code | 409 | 548 | 758 | 1332 | 1791 | 2139 | 523% |
| Regulations | 987 | 2960 | 3148 | 4407 | 5861 | 6958 | 705% |
| Total | 1396 | 3507 | 3906 | 5739 | 7652 | 9097 | 652% |

Sun-setting Tax Laws. According to the 2012 TAS report: *"The tax code contains more than 100 provisions that expired at the end of 2011 or were set to expire at end of the 2012, up from about 21 in 1992."* Sun-setting tax provisions are often designed to disguise the true long term budgetary impact of tax provisions (e.g., the annual AMT "patch"). Sun-setting tax laws also add uncertainty to the planning process as advisors wonder what happens if the sunset occurs. For example, The Economic Growth and Tax Relief Reconciliation Act of 2001 provided that: *"[t]he Internal Revenue Code ... shall be applied and administered... as if the [2001 Act] had never been enacted."* For the next 12 years, tax practitioners scratched their heads about the scope and impact of a retroactive revocation of the massive 2001 Tax Act - while hoping Congress would have the good sense not to let it happen

Constant Changes. While Congress may have made the Bush tax cuts permanent in January, the tax community is already anticipating the next round of tax changes. For example, President Obama's recent budget proposal provides that the estate tax exemption is reduced to $3.5 million in 2018. According the 2012 TAS report: *"There have been approximately 4,680 changes to the tax code since 2001, an average of more than one a day."* These changes do not include the 154 pages of the American Taxpayer Relief Act of 2012 ("ATRA") that was enacted on January 2, 2013. CCH has indicated that between 2000 and 2010, Congress made 4,428 changes to the Tax Code, including 579 in 2010. In 2006 the IRS Commissioner testified to Congress that since the tax reform in 1986, "*Congress has passed 14,400 amendments to the tax code. That's an average*

*of 2.9 changes for every single working day ... for the last 19 years.*" Congress's continuing propensity to modify the Tax Code requires a constant updating of tax and investment plans.

The failure of the IRS to promptly update the Treasury Regulations after the enactment of new tax legislation adds another layer of uncertainty. As a consequence, advisors lack precise guidance on the IRS positions and have to work with out of date regulations.

Incomprehensible Tax Law. Congress has enacted a number of incomprehensible Code sections - cynically, perhaps so the perceived benefit of the Code section evaporates. For example, in 1997 Congress adopted Code §2033A which provided family business estate tax exclusion. The exclusion was later revised (as Code §2057) to be a tax deduction. Both Code sections were so imprecise and had so many conditional variables that they were virtually useless, because taxpayers had no certainty that they could rely upon the Code provision to escape an estate tax liability - and if they were wrong, penalties and interest could add to the tax pain. I started working on an article on §2033A in 1998 and after 50 hours of work, threw the article away because it seemed impossible to properly analyze the new rules.

Elusive Tax Benefits. While not incomprehensible, some purported tax benefits are subject to conditions that effectively render them unusable - making many tax practitioners wonder if the tax provision was just a political gimmick. For example, in 1993 Congress offered a special tax break in Code §1202, designed to help small business owners raise capital by reducing the capital gain rate on investors by 50% (temporarily increased to 100% in the Small Business Jobs Act of 2010) if certain conditions were meet. According to the Senate Finance Committee, the stated purpose of the bill was: *"The Committee believes it is important to maintain a larger exclusion for stock in small, start-up enterprises. Such enterprises are inherently risky and may not have easy access to the capital necessary to launch a new venture. The Committee believes that it is important to foster such entrepreneurial activities and believes targeted reduction in capital gains taxation will help provide access to needed capital."* However, the §1202 restrictions effectively eliminated the benefit to most small businesses:

- The tax break only applied to investments in C corporations. Most new startup businesses are created as LLCs, Partnerships or S corporations.
- As a C corporation, neither the business owner nor the investor could personally write off any business losses created in the early years of the business.
- Redemptions of stock were significantly restricted.
- The exclusion was treated as an AMT preference, reducing the true tax benefit.
- The stock must be held for at least five years.

Ambiguity. You might hope that the underlying mathematics of the Tax Code would create precision in the wording of the tax rules. Unfortunately, that is often not the case. For example:

- Charitable Deduction Appraisals. Treasury Regulation §1.170A-17(a)(9) addresses the issue of how long you need to retain an appraisal used for a charitable deduction by providing: "*The donor must retain the qualified appraisal for so long as it may be*

*relevant in the administration of any internal revenue law."* In other words, figure it out for yourself, we're not going to tell you.

- Business Deduction. The Code §2057 family business ownership deduction (eliminated for 2004) provided in §2057(e)(2)(D) that the deduction excluded: *"that portion of an interest in a trade or business that is attributable to cash or marketable securities, or both, in excess of the reasonably expected day-to-day working capital needs of such trade or business."* No objective standard was provided in the statute or regulations to define the reasonable day to day working capital needs of the business. The committee report indicated that use of a *Bardahl* formula might be appropriate.
- Resident Aliens. The United States taxes the world wide income and assets of its resident aliens, so defining a "resident alien" is a critical definition. For income tax purposes, a "resident alien" is defined in Code §7701(b)(1)(A) in fairly objective terms. However, for transfer tax purposes, Treasury Regulation §20.0-1(b)(1) and 25.2501-1(b) provide: "*A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal*." (emphasis added). How exactly do you prove your "present intent" of not planning to leave the US?

Form over Substance. One of the particular oddities of the Tax Code is how two transactions that create the same economic result can be taxed differently. For example, assume there are two owners of a C corporation. One of them dies and his estate sells his 50% interest to the other shareholder for $500,000. In that transaction the purchaser's tax basis in the corporation increases by $500,000. But assume, the transaction was a corporate redemption for $500,000. Although both transactions result in the surviving shareholder owning 100% of the corporation, in the redemption, the surviving shareholder's tax basis is $500,000 less than it is in a cross purchase. At a federal capital gain rate of 20%, the difference in form could cost the client $100,000 when the business is sold.

Phased Out Tax Provisions. Tax benefit phase-outs are an effective means of raising the effective tax rates without touching §1 of the Tax Code. Both political parties use the tax illusion. There are 19 separate Tax Code provisions which deny benefits to taxpayers once they reach certain levels of income. According to the 2012 TAS report: *"Roughly half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes."* The complexity is magnified because the income levels at which the phase-outs occur are not remotely uniform. See a summary of the phased out tax benefits at the Tax Policy Center website: http://www.taxpolicycenter.org.

Exceptions and Limitations. Deductions, credits, exclusions, exemptions, exceptions, limitations to exceptions and exceptions to the limitations - it can drive you crazy. For example:

- <u>Corporate Losses</u>. Code §1244 provides the perfect example of the complicated insanity of the Tax Code. In 1958 Congress adopted Code §1244 which provides an ordinary loss to individual investors in certain small businesses corporations. Current law provides for numerous limitations and exceptions, including the following <u>partial</u> list:
    - *Limitation#1*: The loss is limited to $50,000
        - *Exception*: Married taxpayers who file a joint return can receive a $100,000 ordinary loss.
    - *Limitation #2*: Normally, the loss is limited to the taxpayer's basis.
        - *Exception*: If the adjusted basis (for determining loss) of such property immediately before the exchange exceeded its fair market value, then the basis for the write off is reduced by the excess.
        - *Exception*: Increases in the taxpayer's basis are not taken into account, including additional contributions to capital, if no new stock was issued.
    - *Limitation #3:* Only individuals can take the ordinary loss. Corporations, trusts and estates cannot take the loss.
    - *Limitation #4:* The qualified stock must be owned by an individual or a partnership. Stock owned by an S corporation, trust or estate does not qualify.
    - *Limitation #5:* The stock must have been originally issued by the corporation to the individual sustaining the loss or to a partnership as noted below. An individual who acquires stock from a shareholder by purchase, gift, devise, or in any other manner is not entitled to an ordinary loss. Therefore, the shareholder's estate is not entitled to the loss.
    - *Limitation #6:* If a partnership owned the stock, then the individual partner taking the loss must have been a partner when the stock was issued to the partnership.
    - *Limitation #7:* The ordinary loss deduction of a partner is limited to the lesser of the partner's distributive share at the time of the issuance of the stock or the partner's distributive share at the time the loss is sustained.
    - *Limitation #8:* Ordinary loss treatment is not available to a partner to whom the stock is distributed by a partnership.
    - *Limitation #9*: The corporation creating the loss must be a domestic corporation.
    - *Limitation #10*: The corporation creating the loss must be a "small business corporation" when the stock was issued, having no more than $1.0 million in capital at the time of stock issuance. Even if it is now a "small business corporation" it will not qualify for the loss. Investments in LLCs and partnerships do not qualify.
        - *Exception*: In making the $1.0 million determination, prior contributions to capital are taken into account, even if those capital contributions have been eliminated by businesses losses.
        - *Exception*: The determination of the $1.0 million uses the corporation's adjusted basis in the contributed property, not its fair market value.

        - *Note*: The definition of a "small business corporation" is not the same definition as used for S corporations, which may not always qualify for 1244 treatment.
    - *Limitation #11*: The stock must have been issued for money or other property. Stock issued for services does not qualify, even if the recipient paid taxes on the receipt of the stock.
        - *Exception*: "Property" excludes stock and securities, apparently even non-publicly traded stocks and securities.
            - *Limit to the Exception*: Stock issued as a non-taxable stock dividend or in an "E" or "F" reorganization may be treated as qualified property.
    - *Limitation #12*: No more than 50% of its gross receipts for the five most recent taxable years before the loss was taken can have come from rents, dividends, interests, annuities, and sales or exchanges of stocks or securities.
        - *Exception*: Only gains on the sales of stocks and securities are taken into account.
        - *Exception*: If the permitted deductions exceed gross income, then this limitation is not taken into account
            - *Limit to the Exception*: In making this determination, no deductions are permitted under Code §§172, 243, 244 and 245.
    - *Limitations #13, 14 & 15:* There are even limits that do not appear in the body of Code §1244:
        - If the stock was issued before July 19, 1984, it is required to be common stock when issued. Preferred stock, even convertible preferred, does not qualify for the loss.
        - If the stock was issued before November 6, 1978, it must have been issued as "section 1244 stock" under a written plan that was adopted by the corporation after June 30, 1958, and on or before November 6, 1978 and the stock must have been issued during a period specified in the plan ending not later than 2 years after the date the plan is adopted.
            - ***Note***: Effectively, stock issued before June 30, 1958 does not qualify for §1244 treatment.
        - Pre-November 1978 stock does not qualify as §1244 stock if at the time of the adoption of the plan under which it is issued there remains unissued any portion of a prior offering of stock. Thus, if any portion of an outstanding offering of common or preferred stock is unissued at the time of the adoption of the plan, stock issued under the plan will not qualify as §1244 stock.
    - *Limitation #16:* Treasury Regulation §1.1244(e)-1 provides: "*A person who claims an ordinary loss with respect to stock under section 1244 must have records sufficient to establish that the taxpayer is entitled to the loss and satisfies the requirements of section 1244.*" The regulation also places record keeping

responsibilities on the corporation. One of the practical problems with such requirements is that finding records of defunct corporations may be impossible.
    - *Limitation #17:* If the stock becomes worthless, one of the frequent issues has been determining the proper year in which the stock was worthless and when the tax loss can be taken.

- Alternative Minimum Tax. Even if you successfully transverse all of the limitations and exceptions of each applicable section of the Tax Code, AMT waits at the check-out as a final limiting layer of complication.

Leftover Tax Laws. There are numerous Code discrepancies that linger in the Tax Code long after there are any significant justifications for their existence. For example, why does the Code have so many restrictions on permitted shareholders of S corporations, while there are no comparable restrictions on LLCs? Why should an LLC and partnership obtain an internal step-up in basis when an owner dies, while no comparable benefit is provided to S corporations?

Other Code provisions have slowly lost their effectiveness because their dollar limits have not changed. For example, the $100,000 limit (for married couples) on §1244 ordinary loss has been the same dollar limit since 1978. If an inflation adjustment had been placed on §1244 in 1978, the loss limit would have grown to almost $350,000.

Varying Definitions. As noted later in this commentary, one of the more humorous tax areas is the widely varying definitions given in the Tax Code. For example:

- Child. The useable definition of a "child" varies widely due to the particular benefit Congress was trying to create. Differences particularly have to do with age. Children under age 19 count in defining EITC benefits, those under 17 qualify for the child credit, and only those under 13 are eligible for the child and dependent care credit. Meanwhile, a "child" for purposes of the "kiddie" tax age stops at age 24 for full time students.
- Family. In a quick review of the Tax Code, the author found at least 16 different ways that family members and related parties are defined.
- Small Business Corporation. The Code has three different definitions of a "small business corporation." See: §§ 280G(b)(5), 1244(c)(3), and 1361(b).

Special Interest Provisions. The Tax Code has long been used to encourage certain political, social and economic approaches (e.g., the mortgage interest deduction fosters home ownership). Unfortunately, the more such provisions grow, the greater the complexity and incomprehension of the Code. Even well intentioned "encouragements" add complexity and distort the burden of taxation. Unfortunately, in the last several years special interest tax breaks have exploded. Part of the problem is that one taxpayer's "tax loophole" is another taxpayer's "legitimate tax benefit." Moreover, once a tax break has been given, taking it back becomes a near impossible task. Here are just a few of the more interesting special tax breaks:

- Whaling Charitable Deduction. Code §170(n) reads*: " In the case of an individual who is recognized by the Alaska Eskimo Whaling Commission as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities and who engages in such activities during the taxable year, the amount described in paragraph (2) (to the extent such amount does not exceed $10,000 for the taxable year) shall be treated for purposes of this section as a charitable contribution."*
- Parsonage Deduction. Code §107 provides: *"In the case of a minister of the gospel, gross income does not include: **(1)** the rental value of a home furnished to him as part of his compensation; or **(2)** the rental allowance paid to him as part of his compensation, to the extent used by him to rent or provide a home and to the extent such allowance does not exceed the fair rental value of the home, including furnishings and appurtenances such as a garage, plus the cost of utilities."* This income exclusion applies even if the minister receives the non-taxable parsonage allowance to cover real estate taxes and mortgage interest that the minister deducts on a personal income tax return.
- Parsonage Allowance after Retirement. Pursuant to Code §1402(a)(8) any parsonage allowance provided to a minister after retirement is not subject to self employment or social security taxes.
- Newsboys. Pursuant to Code §§3401(a)(10), 3121(b)(14) and 3306(c)(15), the earnings of certain people paid for newspaper delivery are not subject to FICA or FUTA taxes.
- ESOP Charitable Deduction. Section 1530 of the Taxpayer Relief Act of 1997 (signed by the President on August 5, 1997) provided that the remainder value of "Qualified Gratuitous Transfers" of "Qualified Employer Securities" passing from a Charitable Remainder Trust to an ESOP qualified for a estate tax charitable deduction pursuant to Code § 2055(a)(5), but only if the ESOP was in existence on August 1, 1996 and the CRT grantor died before January 1, 1999. The general consensus within the tax community was that this 16 month tax provision was specifically designed to benefit a single taxpayer. It has never been reported which politician inserted section 1530 into the bill.

Congress is continually creating new tax incentives to encourage taxpayers to act in a certain manner. Unfortunately, new incentives are often created without eliminating the old ones. For example in 2008 there were 11 different educational incentives and 16 different retirement incentives. Multiple incentives create a new complexity: prioritizing which incentives apply in which order.

Members of Congress seem to have a continuing ability to slip special interest provisions into any tax bill. For example, there were more than 50 temporary tax breaks in the American Taxpayer Relief Act of 2012, including:

- A one year extension of quicker depreciation write-offs for investments in "**motorsports entertainment complexes**" - commonly called the "NASCAR exemption."
- The extension of the tax credit of up to $2,500 for buying electric-powered vehicles was expanded to include electric-powered motorcycles. Oregon Senator Ron Wyden took

credit for this new tax break, saying it would help an Oregon-based company that manufactures electric motorcycles. Every tax bill seems to contain similar provisions.

Compliance and Returns. The IRS's forms and instructions reflect this increasing complexity. Even the simplest forms can be complex. Form 1040EZ for 2012 has 46 pages of instructions, with an estimated 4 hours needed to complete and file the "easy" return - up from 1.5 hours in 1988. The instructions for form 1040 have grown from 2 pages in 1935, to 39 pages in 1975 to 106 pages in 2012.

The complexity is shown in the IRS estimates of the average preparation time for tax returns. The IRS instructions indicate that the average time to prepare each of the following returns for 2012 is:

- Individual Income Tax Return (form 1040) – 43 hours
  - Schedule C, E or F (i.e., businesses) - 63 hours
- Corporate tax return (form 1120) - 186 hours
  - Schedule M-3 – 89 hours
- S Corporation Return (form 1120-S) - 156 hours
  - Schedule M-3 – 72 hours

The titles given to IRS forms reflect the Code's complexity. For example, Schedule J to Form 1118 is titled: *"Separate Limitation Loss Allocations and Other Adjustments Necessary to Determine Numerators of Limitation Fractions, Year-End Recharacterization Balances, and Overall Foreign Loss Account Balances."* According to the IRS, for 2012, on average, it took 110 hours to prepare this form.

The numbering of tax forms demonstrates the Code's complexity. The IRS has been sequentially adding new form numbers since IRS form #1 was issued during the Civil War. As of April 1, 2013, the highest IRS form number is number 14467– and this ignores all of the related schedules (e.g., Schedules, A, B, C, D, E, F, etc for 1040s). Interestingly, there appear to be unexplained gaps in the form numbers which are used.

The reporting responsibilities of taxpayers and charities have exploded in the last couple decades. Tax compliance creates an often unknown reporting burden (and potential for penalties for non-compliance) on businesses, individuals and charities. For example, how many charities know that Code §6050L requires the charity to file a tax information return with the IRS and the donor if they sell a donated asset (excluding marketable securities) within three years after receipt, if the asset was worth more than $5,000?

Alfred E. Neuman was right: *"Today, it takes more brains and effort to make out the income-tax form than it does to make the income."*

Complexity and the Paid Professional. According to the 2012 TAS Report, 59% of individual taxpayers pay someone to do their return, while another 30% purchase software programs such as TurboTax. In 1980 paid preparers only completed 38% of all filed returns.

However, tax preparer penalties and recent rulings have undercut the extent to which clients can rely upon the advice of their paid professionals - adding another layer of complexity to tax planning. For example:

- In the April 4, 2013 decision of Knappe v. U.S., the Ninth Circuit Court of Appeals ruled that an Executor cannot abate a late filing penalty based upon advice of their accountant on the proper tax return filing date for an estate tax return, when an extension was filed. The Court ruled that the accountant's advice was not substantive and the Executor was not reasonable in relying upon the accountant's unequivocal (but erroneous) advice.
- A number of recent decisions have also provided that reliance upon software tax return programs will not necessarily protect a taxpayer from penalties (c.f., "*Does Reliance on Tax Software Avert Section 6662 Penalties?*" Journal of Taxation, February 2011).
- The growth of tax preparer penalties has added even greater complexity to the tax system, with tax preparers effectively taking on some liability for their clients' filings. See: Lipton & Walton, "*Tax Return Preparer Penalty Final Regulations*," Journal of Taxation, April 2009.

Penalties. Complexity creates purposeful non-compliance and unintended mistakes. The 2012 TAS report notes that *"The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today."* Unfortunately, the enforcement of the current complex tax system may not distinguish between purposeful evasion and true mistakes. Leon Panetta made a salient quote: "*If we don't do something to simplify the tax system, we're going to end up with a national police force of internal revenue agents*."

Even more complexity is added to the mix when the federal courts cannot agree to a similar penalty result based upon similar facts (c.f., "*Courts Still Cannot Agree on When Section 6662 Penalties Apply*," Journal of Taxation April 2012).

State Taxes. State tax laws are becoming more complex:

- Historically, states with income and estate taxes relied upon the federal Tax Code as the base of their own tax systems, with various adjustments. However, states have increasingly decoupled from the federal Tax Code in significant ways, increasing the tax compliance and complexity for taxpayers.
- Tax nexus and apportionment issues are becoming more inconsistent from state to state. For example, New York recently won a case that permitted it to impose sales taxes on sales in which the nexus connection was solely through the internet - the seller did not have a physical presence in the state. A workable national standard for state tax law nexus is overdue.

- In a search for new tax revenues, states are increasingly trying to find creative ways to tax non-residents (e.g., high hotel and car rental fees; higher real estate taxes on homes of non-residents).
- In a search for economic benefits, states are creating special tax breaks for "desirable" businesses (e.g., movie and television production) and residents (e.g., retirees).

Unexpected Tax Results. Mixed into all the words of the Tax Code, Regulations and Rulings are more than a few unexpected results, including a few personal favorites:

- Dependency Deduction. Most people assume that the dependency deduction is limited to family members, but this is not the case. A non-family member can be a dependent. The definition of a "qualifying relative" in Code §152(d)(2)(H) includes *"[a]n individual .... who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer's household*." The person must be a member of the taxpayer's household for the entire year, with partial year residency disqualifying the deduction. See Treasury Regulation §1.152-1(b).

  Interestingly, while the head of the household may qualify for a dependency deduction for someone who is not a blood relation or a relation by marriage, they will not qualify for head of household income tax filing. See: Rev. Rul. 84-89, 1984-1 CB 5.

- Kidnapped Dependent. The Tax Code provides that parents of kidnapped children can continue to claim the child as a dependent until they reach age 18 or are found dead. If the kidnapper is a family member, no dependency deduction is permitted. See: Code §152(f)(6)(A).

- Private Inurnment. Making contributions for the benefit of a deceased police officer's family or providing aid to a neighbor is a common practice in most communities. Churches and other charities often set up funds for that purpose. But is the payment to the charity deductible if it is earmarked to a particular person? The earmarking of the gift to a particular person is not generally entitled to a charitable deduction and in fact may be a taxable gift (and generally covered by the gift tax annual exclusion). See: IRS INFO 2012-0042, dated Dec. 20, 2011; release date June 29, 2012; Revenue Ruling 62-113, 1962-2 C.B. 10; Tripp v. Comm'r, 337 F.2d 432 (7 Circ. 1964); Peace v. Comm'r, 43 T.C. 1 (1964).

- Tax Basis. There are a number of exceptions to the step-up in tax basis of a decedent's assets, including these lesser known provisions:
  - According to the IRS, "net unrealized appreciation" in employer stock distributed from a qualified retirement plan before the death of the participant does not step up to the stock's fair market value. See: Revenue Ruling 75-125, 1975-1 CB 254.

- S corporation stock does not step up to the extent assets of the S corporation would have constituted IRD if held directly by the deceased shareholder. See: Code §1367(b)(4).

- Carry-over Basis in Divorce. Pursuant to Code §1041(a), if property is transferred to a spouse or an ex-spouse as a consequence of a divorce, the recipient spouse gets the full carry-over basis of the transferor. Unlike most gratuitous transfers, the recipient's tax basis is not impacted if the tax basis is higher than the fair market value of the transferred asset. Negative basis property may also be directly transferred to the spouse or former spouse without creating a taxable event for the transferor spouse. See: Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, (WG&L) section 44.6 and PLRs 9615026 and 8644012.

- Installment Sales and Divorce. Code §453B(g) provides that a direct transfer of an installment sale note to a spouse or ex-spouse as a result of a divorce is not treated as a taxable disposition. However, if the transfer is in a trust for the spouse or former spouse, the disposition is taxable to the transferor.

- Death and Alimony. Code §71(b)(1)(D) provides that if there is any obligation to make an alimony payment (or a substitute payment) after the recipient's death, all such payments, including those paid before death, are not treated as alimony. See: Okerson, 123 TC No 14 (2004).

- Carry-forwards of Deceased Taxpayers. Current law provides that a decedent's net operating loss carry-forwards, capital loss carry-forwards, and charitable carry-forwards do not carry over to their estates, heirs or surviving spouse (even if a joint return has been filled by the couple). See: Rev. Rul. 74-175, 1974-1 CB 52 and Treasury Regulation §1.170A-10(d)(4)(iii)). The unused carry-forwards are simply eliminated when the taxpayer dies. However, because the law provides that a married decedent's final tax return reflects his or her income taxes for the period from the beginning of the year to the date of death and reflects all of the income of the surviving spouse for that year, surviving spouses do have the capability (if they have sufficient facts in their favor) of using the carry-forwards of a deceased spouse on their final joint income tax return.

- Post-Mortem Estimated Taxes. Estimated income tax payments are not required after a taxpayer's death. See Treasury Regulation §1.6153-1(a)(4).

- Electing out of Social Security. Pursuant to Code §1402(e)(1) a minister who meets certain qualifications can elect out of the social security system by filing IRS form 4361 by the due date of the form 1040 for the second year the minister had at least $400 of ministry related income. Pursuant to Code §1402(g) members of certain religious orders can also elect out of the social security system.

- Fiduciary Earned Income. When a fiduciary receives a payment for performing fiduciary functions, the income is taxable at ordinary income tax rates. However, unless the fiduciary is in the trade or business of serving as a fiduciary, the income is not generally subject to self-employment or payroll taxes. Rev. Rul. 58-5, 1958-1 CB 322, and McDowell v. Ribicoff, 8 AFTR 2d 5016 , 292 F2d 174 , 61-2 USTC ¶9514 (CA-3, 1961). But see PLR 9107009 where the fiduciary fees paid to an attorney who served as a fiduciary for 12 trusts were considered self-employment income.

- Gain on Part Sale Transactions. How do you compute the taxable gain from a part sale/part gift transaction (e.g., a net gift)? Treasury Regulation §1.1001-1(e)(1) provides that *"Where a transfer of property is part a sale and in part a gift, the transferor has gain to the extent that the amount realized by him exceeds his adjusted basis in the property."* As confirmed by the examples in the above regulation, the entire basis is used to compute the recognized gain - not an amount proportionate to the sale portion of the transaction.

- Losses on Annuities. Revenue Ruling 61-201, 1961-2 CB 46, permitted an ordinary loss where the Variable Annuity was a "refund" annuity originally purchased by the selling taxpayer. There is no deduction for surrender charges. The central issue is not the deduction, but where you take it on the tax return:
    - On Line 14 of 1040 as "Other Gains & Losses"?
    - As a Miscellaneous Itemized Deduction? Subject to a number of potential limits:
        - ✓ 2% AGI Limit
        - ✓ Itemized Deduction Phase-out
        - ✓ Alternative Minimum Tax

- Babysitting. If you hire a babysitter so you can do your charitable volunteer work, you may be entitled to a charitable deduction for the payment. According to Kinglesy vs. Comm'r, T.C. Summ. Op. 1978-74, the deduction is valid. The court rejected the IRS's contrary view contained in Revenue Ruling 73-597, 1973-2 CB 69.

- Charitable Disclosure. Effective for tax years beginning after January 1, 2007, Congress revised IRC §6104(b) to require the IRS to disclose information for various types of charitable trusts as reported on IRS form 5227. While taxpayers generally have an expectation that information with regard to any trust that they have created is not subject to public disclosure, this form is available to the public and, as a result, clients are receiving solicitations for their charitable trusts.

- Virgin Islands. Code §932 and §934 provide significant tax benefits for US citizens who move to the Virgin Islands and open a business that employs a minimum number of local residents.

- IC DISCs. An IC DISC is a special domestic corporation which can significantly reduce a corporation's taxes on its export income. See: Losi, "*The Last Remaining Export Incentive Just Got Some Staying Power,*" Practical Tax Strategies, March 2011.

- Common Paymaster. Commonly controlled corporations can reduce their payroll taxes for commonly employed workers using the "common paymaster" rules. Code §3121(s) reads: *"For purposes of sections 3102 [Deduction of Taxes from Wages], 3111 [Rate of the Payroll Tax] and 3121(a)(1), if two or more related corporations concurrently employ the same individual and compensate such individual through a common paymaster which is one of such corporations, each such corporation shall be considered to have paid as remuneration to such individual only the amounts actually disbursed by it to such individual and shall not be considered to have paid as remuneration to such individual amounts actually disbursed to such individual by another of such corporations*." A similar provision is contained in Code § 3231(i). These "common paymaster" rules do not generally extend to non-corporate entities or to Qualifying Subchapter S subsidiaries. Treasury Regulation §301.7701-2(c)(2)(iv) provides that a single-owner LLC that has not elected to be taxed as a corporation is disregarded as an entity separate from its owner for income tax purposes and is considered an unincorporated branch or division of its owner. However for employment tax purposes, it is treated as a separate entity - potentially increasing the employment payroll costs of common employees. There is a special exception for certain faculty medical practice programs. However, a disregarded entity may file IRS Form 2678, designating an agent (such as the owner of the disregarded entity) to pay and file employment related taxes. But, the entity may not normally designate a payroll agent for purposes of FUTA taxes (IRS Form 940). The states deal with the common paymaster rules in significantly different ways. For example, for state payroll tax purposes, Texas does not permit the use of common paymaster accounting.

- Numbering. Does anyone know why Code §675 does not follow the same paragraph numbering system as the rest of the Tax Code?

**Cost of Complexity**. According to the 2012 TAS, U.S. taxpayers directly spend $168 billion a year complying with income tax requirements, an amount that equals 15% of the total amount of income taxes collected. According to an April 2011 report issued by The Laffer Center, the cost of compliance may actually equal $431.1 billion per year, when man hours and secondary costs are considered.

The 2012 TSA report notes:

- *"If tax compliance were an industry, it would be one of the largest in the United States."*
- Taxpayers spend 6.1 billion hours a year complying with the Tax Code - the equivalent of three million full time workers.
- Taxpayers spend 18 million hours computing their potential liability under AMT.

Without question, the uncertainty and complexity fostered by a complicated Tax Code inhibits economic decision making.

**Public Perception**. Perhaps the most significant result of all of this complexity is a general public perception that the Tax Code is unfair and unevenly enforced. The 2012 TAS report noted this perception: *“In 2012, TAS conducted a statistically representative national survey of over 3,300 taxpayers who operate businesses as sole proprietors. Only 16 percent said they believe the tax laws are fair. Only 12 percent said they believe taxpayers pay their fair share of taxes.”*

A 2004 IRS Oversight Board’s Taxpayer Attitude Survey indicated that about 20% of Americans believed that some degree of tax cheating is acceptable.

Page 4 of the President’s 2005 Advisory Panel on Federal Tax Reform stated: *"[T]axpayers think that with the myriad of targeted exclusions, deductions, and credits, others may not be paying their fair share – so why should they? Some call this 'the cheat or chump syndrome.' In addition, clever tax advisors mine the complexity of the tax code to develop and market tax shelters and other schemes clearly designed to manipulate the tax code’s hidden loopholes for their clients’ exclusive benefit. The perception that the tax code is unfair and easily manipulated undermines voluntary compliance – the foundation of our tax system."*

This public perception creates an environment where cheating on your taxes may seem justified. In a report issued January 7, 2012, the IRS reported that the following non-compliance numbers (dollars in billions):

| | 2001 | 2006 |
|---|---|---|
| Gross Tax Gap | $345 | $450 |
| Voluntary Compliance | 83.7% | 83.1% |
| Underreported | $285 | $376 |
| Non-Filing | $27 | $28 |
| Underpayment | $33 | $46 |

**Why is the Code so Complex?** This is kind of like asking about the meaning of life - hard to get a good answer, but everyone seems to have an opinion. Here are at least a few of the reasons that the Code is so complex - recognizing that the issue is exceedingly complicated.

<u>Lobbying for Tax Breaks has become a Big Business</u>. According to an article on Reuters on March 25, 2013, there are over 1,700 tax lobbyists registered in Washington. A December 2011 report from the Public Campaign (a self-styled non-partisan group) identified thirty major US corporations that paid more for Congressional lobbying then they did in federal income taxes from 2008 through 2010.

Tax Reform probably requires Campaign Finance Reform. Tax reform always means there will be winners and losers in any changes. It also becomes a great fund raising tool for politicians on both sides of the discussion. The Center for Responsive Politics calculated that the 2012 national elections cost at least $6.3 billion, with $2.6 billion spent on the Presidential election and $3.6 billion on Congressional elections. Money speaks and the winners get to determine the tax rules. When the winning party changes, the Tax Code almost always gets more complicated.

Tax Code Engineering. Washington has a continuing propensity to use the Tax Code to create "desirable" incentives for the American public. Members of Congress are constantly inserting special provisions in the Code to benefit their donors and local businesses. Whether you agree with the incentives or not, they inevitably add complexity to the Tax Code.

The Congressional Two-Step. As noted above, Congress will sometimes adopt a tax change that is illusionary, but which has great titles and lofty slogans, with little real impact.

Public Attitudes. While most of those paying federal and state income taxes would like to see their taxes reduced, there is another perspective that may continue some of the current complexity. In an April 2011 Gallup poll, 47% of Americans said that they believe *"our government should ... redistribute wealth by heavy taxes on the rich.*"

Reform is Myopic. Particularly in recent years, new tax bills have tended to have little strategic or long term planning imbedded in the changes. Most have been focused on short term concerns, such as economic recovery or political posturing. As such, the rules do not generally make long term economic sense. For example, according to the Congressional Budget Office, ATRA will obtain $600 billion in new revenue (mainly from the highest income earners), while adding $3.971 trillion to the federal deficit in the next 10 years (i.e., $3.638 trillion in lost revenue and $332 billion in new spending).

Reform means Tax the Other Guy. For most people tax reform is about raising someone else's taxes while lowering their own taxes. Former Senator Huey Long understood this perspective: *“Tax reform means Don't tax you, don't tax me. Tax that fellow behind the tree.”*

Revenue Drives the Process. Many of the complexities are added as Washington seeks to either retain certain budget goals or seeks to disguise the true economic impact of a tax change. For example, there are 19 tax benefits which are phased-out as taxpayers reach certain levels of income. Much of the decision making on setting the break points is determined by budget scoring, instead of consistency or simplicity.

Repeal of Aged Tax Provisions. There is rarely a stand alone reason for repealing an out of date tax provision. As a result there remain numerous tax provisions that have not kept up with the legal, economic and business developments and serve as impediments to business and financial

decisions. For example, the restrictions on S corporation ownership and the §1244 limits on ordinary losses for business failures make little sense in the current economy.

**Practicing in Complexity**. All of this complexity creates a number of tax practice imperatives that tax advisors should consider, including:

- Never think you know all of the exceptions, limitations, definitions, exclusions and unexpected consequences of any tax matter. Run most client issues through the Code and regulations rather then relying upon your memory.
- In most instances, it is strongly advisable to run the math and see the final result of any tax advice. There are too many limitations affecting income, deductions, and credits to do it in your head and the actual results will often surprise you.
- When the tax law changes, spend the time to review both the terms of the law and their implications.
- In most tax planning, adopt as flexible an approach as possible so that unexpected events or problems can be fixed as well as possible.
- Narrow your tax practice niches to those areas you know well. Don't cavalierly wander into other niches without doing substantial study and research.
- Know what you don't know. For example, if you are not going to keep up with the rules governing qualified plans, or Medicaid planning, or tax controversies, stay out of the niches.

**The Humor and History of Taxation**. But some of tax rules provide a peculiar tax humor for their complexity - or in some cases, simplicity. Tax history can be equally interesting. Here are just a few personal favorites:

Definitions. The definitions in the Tax Code can get interesting. For example:

- Defining the Charity. Definitions can be incomprehensible. A portion of IRC §509(a) reads: *"For purposes of paragraph (3), an organization described in paragraph (2) shall be deemed to include an organization described in section 501(c)(4), (5), or (6) which would be described in paragraph (2) if it were an organization described in section 501(c)(3)."* Interestingly, Ronald Regan used this sentence as an example of the need to simplify the Tax Code - but it remains a part of the Code.
- Computers. Definitions can be simple: IRC §168(i)(1)(B) provides: *"Computer or peripheral equipment defined. For purposes of this paragraph (i) In general. The term "computer or peripheral equipment" means (I) any computer, and (II) any related peripheral equipment.*" Subsequent parts of the Code section do provide a more complete definition.
- Non-Traded Stock. Treasury Regulation §1.170A-13(c)(7)(ix) provides that "*the term 'non-publicly traded stock' means any stock of a corporation (evidence by a stock certificate) which is not a publicly traded security*."
- Spouses. Code §7701(a)(17) reads: *"As used in sections 682 and 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such sections, the term "wife" shall be read "former wife" and the term "husband" "shall be read "former husband"; and, if the payments described in such sections are made by or on behalf of the*

*wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such sections, the term "husband" shall be read "wife" and the term "wife" shall be read "husband."*

- Family. The definitions of family members and related party can get interesting. For example:
  - In-Laws. Code §4946 provides that" "*For purposes of subsection (a)(1), the family of any individual shall include only his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren, and great grandchildren*." This ironically means that you are a member of your spouse's parents' family, but they are not a member of your family. Try explaining that to your in-laws.
  - Related Party. Code §672(c) says that: "*For purposes of this subpart, the term "related or subordinate party" means any non-adverse party... who is the grantor's spouse if living with the grantor*." So if your spouse lives across the country or moves across the street, the application of the definition changes?
  - Qualifying Relative. The definition of a "*qualifying relative*" in Code §152(d)(2)(H) can include someone who is not related to you by blood or marriage.
  - Family. The Tax Code defines family members and related parties in at least 16 different ways.
- Alimony is Earned Income. Code §219(f)(1) provides that alimony is considered earned income for IRA purposes. Interestingly, Code §219(f)(7) provides that non-taxable combat pay is also treated as earned income for IRA contribution purposes. Is there a theme here?

Wordy Code Provisions. One sentence in IRC §341(e)(1) which defined a "collapsible corporation" (and was repealed in 2003), contained 342 words, 25 parentheticals, 7 commas, 2 dashes and 1 period. Try diagramming that sentence. For the readers who are less than fifty years old, ask your parents what "diagramming that sentence" means.

Incomprehensible Formulas. Here is the IRS formula in Treasury Regulation §1.170A-12 formula for the valuation of a remainder interest in real estate. Even Einstein might have had a problem with this formula.

$$(1+\frac{i}{2})\sum_{t=0}^{n-1} v^{(1+t)}[(1-\frac{l_{x+t+1}}{l_x})(1-\frac{l_{y+t+1}}{l_y})-(1-\frac{l_{x+t}}{l_x})(1-\frac{l_{y+t}}{l_y})](1-\frac{1}{2n}-\frac{t}{n})$$

Historic Federal Taxes. As if the current tax rules were not odd enough: Congress has imposed and later repealed a number of interesting federal taxes:

- A $20 federal tax on "One Worm" - figure that one out.
- A tax on manufacturers and users of stills - but there was little compliance down South.
- An annual tax on traveling peddlers, with the amount of the tax determined by their mode of transportation.

- In the 1920s there were a number of annual special federal taxes:
    - A $10 tax imposed on vehicles for hire (e.g., taxis)
    - A $10 tax on a "User of Motor Boat"
    - A $100 tax on Circuses
    - A $200 tax on Theaters
- A federal tax on marijuana distribution during the 1930s.
- An annual $100 "special tax" on slot machines during WWII.

The Long Arm of the Tax Authorities.

- The first recorded imprisonment for tax evasion was by Roman Emperor Constantine in 306 A.D.
- In 1931, Al Capone was convicted of federal income tax evasion. He was too smart to get convicted of running booze or for murder.
- In 1990, the IRS seized the Mustang Ranch Brothel in Nevada and ran it in an attempt to pay the owner's back taxes.
- Prosecutor Ann Donnelly asked former Tyco CEO Dennis Kozlowski at his trial for securities fraud: "*You did not notice $25 million was missing from your W-2?*" His answer: "*That is absolutely correct, I did not*." Judging by the verdict, the jury was not amused.
- The courts have ruled that "street-hustling" can be a trade or business subject to self employment taxes and income taxes. No one escapes the long arm of the revenue collector. See: Basada v. Comm'r, TC Memo 1998-144.

Taxes in History. History has its own share of interesting tax facts:

- Ancient Greece revered the tax collector as the noblest man in society. My.... how times have changed.
- Julius Caesar imposed a 1% sales tax on the Roman Empire.
- The Roman Emperor Bespasian imposed a tax on urine, when used for cleaning and tanning leather.
- In 1696 England imposed a "window tax" that was based upon the number of windows in a building. Spain and France had similar taxes. As a result, property owners boarded up many of their windows.
- In 2200 BC, the Chinese emperor Hsia Yu levied one of the first known taxes. He taxed salt.
- Gandhi's first act of civil disobedience against the British rule in India was to protest the British Salt Tax.
- In 2011 Romania imposed a tax on witches.
- Income Taxes in World History:
    - In 10AD, Chinese Emperor Wang Mang imposed a 10% income tax.
    - In 1188 Richard the Lionhearted imposed the "Saladin tithe" of 10% of each layperson's income and moveable property to fund the Third Crusade.

- In 1199, Pope Innocent III imposed an annual "Papal Income Tax" on one-fortieth of the ecclesiastical income of Catholic clergy to pay for the Crusades.
- In 1404 England adopted a new income tax. The tax was so despised that Parliament had all records of the tax burned. The income tax was re-enacted in 1798 in preparation for the Napoleonic War. When it was repealed in 1816, the records were again burned.

- Income Taxes in United States History:
  - A federal income tax was proposed during the War of 1812, but hostilities were over before a bill could be enacted.
  - The first federal individual income tax was enacted in August 1861 to fund the Civil War. The initial top tax rate was 5%, which increased to 10% during the war.
  - The second individual federal income tax was imposed in 1894 at a top rate of 2%. In 1895 the US Supreme Court ruled that the tax was unconstitutional.
  - In 1913, the Sixteenth Amendment was ratified by the required number of states and individual income taxes were re-imposed, at a top marginal rate of 7%. The bill supporting the Sixteenth Amendment was passed by Congress on July 12, 1909.
  - The first US state to impose an income tax was Wisconsin in 1911. As of 2013, Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not impose any individual income taxes.
  - The first major US city to impose an income tax was Philadelphia.
  - The United States had its top income tax rate of 94% during WWII - President Roosevelt wanted a 100% rate, but Congress apparently thought that his request was excessive.
  - Federal wage withholding started as a "temporary" measure during World War II, but Congress never got around to repealing it after the war was over.
  - In 1987, after the IRS started requiring dependent social security numbers on taxpayers' federal income tax returns, approximately 7,000,000 dependents mysteriously disappeared.
- The first federal estate tax was imposed in 1797 to fund a naval buildup during John Adam's administration.
- The first federal gift tax was imposed in 1862 to fund the Civil War.
- When social security was enacted in 1935, the combined employer/employee tax rate was 2% on the first $3,000 of earned income - or a maximum of $60 per year.

Humorous Tax Quotes. All of this complexity creates a number of humorous tax quotes and comments, including:

- *“If Patrick Henry thought that taxation without representation was bad, he should see how bad it is with representation.”* The Old Farmers Almanac
- *“A society which turns so many of its best and brightest into tax lawyers may be doing something wrong.”* Hoffman F. Fuller

- *"For every Tax Problem there is a Solution which is Straightforward, Uncomplicated and **Wrong**"*
- *Hiring a tax expert isn't always a help. If you give the same problem to three tax experts, you are likely to get at least six different answers."*
- *A tax lawyer is a person who is good with numbers but does not have enough personality to be an accountant.* James D. Gordon, III
- *Definition of a Tax Attorney: Someone who solves a problem you didn't know you had in a way you don't understand.*
- *"We could give it all back to you and hope you [the American people] spend it right."* President Clinton discussing how to spend the budget surplus. (1999).
- *"The President has kept all of the promises he intended to keep"* Clinton aide George Stephanopoulos
- *"This [preparing my tax return] is too difficult for a mathematician, it takes a philosopher."* Albert Einstein
- *"Nuclear physics is much easier than tax law. It's rational and always works the same way."* Jerold Rochwald
- *"And I must say that the Republicans, I think, have been cutting taxes with borrowed money, and the Democrats have been spending with borrowed money. They agree only on the borrowed money."* Alan Greenspan on PBS, September 24, 2010
- *"Those with the least votes will pay the most taxes."*
- "*The difference between death and taxes is death doesn't get worse every time Congress meets*." Will Rogers
- "*It is a good thing that we do not get as much government as we pay for*." Will Rogers
- *"The art of taxation consists in so plucking the goose as to obtain the largest amount of feathers with the least possible amount of hissing."* Louse XIV's Controller-General of Finance
- *"Definition of a corporate tax shelter: A deal done by very smart people that, absent tax considerations, would be very stupid."* Michael J. Graetz
- A new Word: **Intaxication (n.)**: Euphoria at getting a tax refund, which lasts until you realize it was your money to start with.
- Did you ever notice that when you put the words "The" and "IRS" together, it spells "THEIRS?"
- There are reports that form 1040 is actually a secret code: for every **$50** you earn, you get to keep **$10** and the IRS gets to take **$40**.

Urban Tax Myths. As you might expect, there are a number of untrue but interesting urban tax myths that have grown up over time, including:

- Not using the IRS provided pre-printed address label removes you from the potential IRS audit base. Nothing removes you from the long arms of the tax auditor, except perhaps death and even then you have to wait for the statute of limitations to run.
- The IRS has moved it headquarters from Washington to Costa Rica.

- The top income earners do not pay their "fair share" of the taxes. According to the IRS, for 2009 the top 10% of taxpayers paid 70.5% of all income taxes, while the bottom 50% paid 2.25% of all income taxes. The percentage paid by the top 10% is going up in 2013.
- If you write "*Unconstitutional*" on the front of your income tax return and send it to the IRS, they will never tax you again. It will not work, but it is an assured way to gain attention from the IRS!
- A similar argument to the above tax evasion idea is that "*Filing a tax return violates my Fifth Amendment right against self-incrimination!"* Let's just say that the courts have not been sympathetic to the argument and most of its vocal proponents are eating at the government's expense.
- A similar argument is that the income tax is a "voluntary" tax. The theory gores that all you have to do is stop volunteering to pay it and the IRS will leave you alone. They will leave you alone - behind some 30 foot concrete walls.
- African Americans are entitled to a $5,000 "slavery reparation tax credit."
- Members of Congress do not pay any social security taxes. Contrary to the myth, they have been paying into the social security system since 1984.

State Tax Laws. And then there is always the interesting array of state tax laws, including these gems:

- In Alabama you can deduct $1,000 for building a radioactive fall out shelter. See Alabama statute 40-18-15 (a)(15).
- Although clothing is generally exempt from the Minnesota sales tax, fur clothing is specifically subject to the sales tax. See Minnesota statute 297A.67.8(c)(9)
- In Utah a special 10% tax is imposed on sexually explicit businesses. See Utah statute section 59-27-103.
- In Texas, there is a $5.00 tax on admission to strip clubs. See Texas statute 102.052.
- In Tennessee there is a "litigation tax" imposed on the filing of "*every original civil and criminal case before each court*." See Tennessee statute 17-512.
- Arkansas has a 6% sales tax on tattoos and body piercings.
- In Connecticut adult diapers are not subject to a sales tax - but baby diapers are subject to the tax. See Connecticut statute 12-412(53). Guess it's a matter of who's voting.
- Alabama has a 10% "privilege tax" on any business or person who "*sells or stores or uses or otherwise consumes packages of playing cards containing not more than 54 cards*." In addition, each retail dealer who sells playing cards pays an annual license tax of $2. See Alabama statute 40-12-144.
- California has a 33% sales tax on cold food, hot coffee, hot chocolate and hot tea purchased from vending machines. See California statute 6359.2(d).
- In over 23 states if you acquire illegal drugs you are required to report the purchase to the state revenue authorities and pay a illegal drugs tax. There appears to have been little voluntary compliance, but it has been a nice revenue sources for many states after drug busts occur.

- In Vermont (and many other states) funeral charges are not subject to sales taxes. See Vermont Statute 22-9741(22).
- In many states, the sale of the United States flag is not subject to a sales tax.
- In Connecticut, *"[t]he sale, furnishing or service of water, steam <u>and telegraph</u> when delivered to consumers through mains, lines, pipes or bottles*" is exempt from sales tax (emphasis added). See Connecticut statute 12-412(3)(C).
- Mississippi imposed the first sales tax in 1932 to add revenue during the depression. As of 2013, the only states without a general state-wide sales tax are Alaska, Delaware, Montana, New Hampshire and Oregon.

There are also lots of interesting state and local taxes that have been eliminated over the years, including:

- A lard substitute tax in South Dakota to encourage the use of lard.
- A South Dakota tax on "Butter Substitutes"
- A special tax in Louisiana for support of Confederate Veterans
- A Greenville, South Carolina tax for a "Lunatic Asylum" in the late 1860s
- A Nashville, Georgia "Whisky Tax"
- Special taxes were once imposed on dealers and manufacturers of oleomargarine to protect the butter industry.
- A tax on Missouri bachelors between the ages of 21 and 50.
- A cleaning tax in North Carolina.
- A cosmetics tax in Ohio.
- A frontier tax in Texas.
- A moth tax in Maine and Massachusetts.
- A terrapin tax in South Carolina when terrapins were considered a delicacy in New England at the beginning of the last century.
- A crab, shrimp and oyster tax in Georgia.
- Until Roosevelt's New Deal, most states and/or local governments imposed a "poor tax" on their residents.

**Presentation**. The author has created three presentations related to this commentary which extensively use Power Point slides. Other presentation topics can be found at <u>www.scrogginlaw.com</u>. Contact me at <u>john@scrogginlaw.com</u> if you would be interested in a presentation to your group.

- A 45-60 minute presentation that focuses on the humorous history of taxes.
- A "Tax Jeopardy" game show on unexpected tax consequences and tax history.
- A 60 minute presentation on the complexity of the Tax Code.

# CONCLUSIONS:

There are a number of conclusions. First, much of the Tax Code has become incomprehensible to

most people, including the IRS, skilled tax practitioners and federal judges. It needs a total overhaul, but the current political environment makes significant reform unlikely.

Second, the complexity and uncertainty of the Tax Code is a drag on the economy in both the costs incurred by taxpayers and by the pervasive confusion and mistrust of the Code. To have a competitive economy, we need to have a Tax Code that its citizens reasonably understand and trust. The Code needs to have a reasonable correlation between the revenue collected and the costs and penalties imposed on taxpayers.

Third, as you watch the process over the decades you may began to understand that significant tax reform is probably impossible without serious campaign finance reform. It seems that whenever some industry or group's tax breaks are threatened, politics and fund raising promptly impede rational economic thought.

Last, don't blame the IRS. They are simply the messenger/enforcer. The IRS has consistently pleaded with Congress to simplify the Tax Code for decades, but to no avail. Neither political party is innocent in the process of complicating the Tax Code, but the IRS usually gets the blame.

The Bottom Line: It is the author's perspective that the complexity of the Tax Code has broken our tax system. Taxes will never be static. There are too many evolving factors to expect or even encourage an unchanging set of tax rules. But what is needed is a simpler and more consistent system that at least looks like it was designed on purpose.

**Major Research Sources:**


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Taxpayer Union Policy Paper 120 (April 18, 2011).
- "*The Economic Burden caused by Tax Code Complexity*," The Laffer Center (April 2011).

**To the Reader**: One of the things I wanted to do in this commentary was to bring to light areas of tax law that readers may not have been aware of. The list of complex and unexpected tax rules is not remotely complete. If you, the reader, have other favorite odd or unexpected tax rules, send them to me (with sufficient detail and references) and we will put together an updated list of the best examples, with attribution to you. My email address is John@scrogginlaw.com.

**HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!**

Jeff Scroggin

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