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2002

The Janus-Like Nature of Treasury Regulations: Recent Promulgations Illustrate How Regulators Can Simplify as Well as Complicate Administration of the Internal Revenue Code

RICHARD J. KOVACH*

Treasury regulations, and lesser promulgations issued by the Internal Revenue Service,[1] give federal tax regulators and enforcers tremendous opportunities either to simplify or complicate determinations under the Internal Revenue Code.[2] Despite frequent cries to simplify federal income taxation,[3] demand for services to implement tax planning and compliance continues to fuel a growth industry that employs various kinds of tax practitioners.[4] Once in a while, federal regulators will reinvent prior approaches to the regulation of a problematic tax concept so as to cause discernable simplification contrary to the overall trend towards increasing complexity.[5] Such a reinvention occurred in January 2001 with the issuance of proposed regulations that govern required minimum distributions from qualified retirement arrangements.[6] These regulations, which became final in April 2002,[7] displaced a prior set of proposed regulations, promulgated in 1987,[8] that

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1. As set forth in the Numerical Finding List of the Internal Revenue Cumulative Bulletin, these lesser promulgations include announcements, notices, revenue procedures, and revenue rulings issued by the Internal Revenue Service. *See* 2001-1 C.B. iv-v (2001).

2. Despite its size, the Internal Revenue Code cannot contain all the rules needed to regulate taxation for so large and sophisticated an economy as that of the United States. Consequently, the Code expressly delegates rule making authority to the Treasury Department. *See* I.R.C. § 7805(a) (West 2002).

3. An organization known as the National Taxpayer Advocate has repeatedly stressed in Congressional reports that complexity of the Internal Revenue Code is the greatest problem facing America's taxpayers, who have much difficulty understanding even the most basic aspects of federal tax laws. *See Practioners' Corner: Complexities That "Defy Explanation" Top National Taxpayer Advocate's 2000 Report*, CCH FED. TAX WEEKLY, Jan. 11, 2001, at 21, http://tax.cchgroup.com/primesrc/bin/highwire.dll.

4. In recent years, professionals who assist taxpayers (not always with clear immunity under unauthorized practice of law rules) include financial planners, various employees of financial institutions, business consultants, pension consultants, and employees of tax return preparation firms, in addition to attorneys and accountants.

5. *See infra* Part II.C. for a discussion of how substantial simplification of depreciation deduction rules occurred as a direct result of Congressional action.

6. *See* Prop. Treas. Reg. § 1.401(a)(9), 66 Fed. Reg. 3928, 3929 (Jan. 17, 2001). In general, I.R.C. § 401(a)(9) requires that distributions from a qualified retirement trust must commence shortly following a plan participant's reaching age 70 ½, thus assuring income recognition under I.R.C. § 402(a).

7. T.D. 8987, 2002-19 I.R.B. 852.

8. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, 52 Fed. Reg. 28,070 (July 27, 1987).

introduced mind-numbing complexity into the minimum distributions compliance process.[9]

This displacement of complicated regulations, with much easier to use rules, dramatically illustrates the power of regulators to effect tax simplification outside of legislative efforts.[10] This article will use the regulatory turnaround illustrated by the I.R.C. § 401(a)(9) retirement plan minimum distribution rules[11] to examine key elements of rulemaking simplicity. Further, this article will discuss how competing interests of administrators and taxpayers contribute toward the simultaneous promulgation of both simple and complex tax rules despite the apparent virtue of regulatory simplicity in the implementation of income taxation policy.

I. TWO CONTRASTING REGULATORY FACES LOOK DOWN ON QUALIFIED RETIREMENT PLANS

A. The First Attempt to Regulate Retirement Plan Minimum Distributions

Tax practitioners, forced to struggle with the 1987 proposed regulations[12] that offered guidance for determining minimum required distributions from qualified retirement arrangements,[13] found themselves engaged in a most unpleasant task. Those professionals conscientious enough to give serious study to the problem often found their way to seminars, books, or internet sites that offer voluminous explanations prepared by a select handful of experts who undoubtedly devoted large chunks of their lives to figuring out how to preserve and maximize the tax benefits associated with large retirement accumulations.[14] Amazingly, a sub-industry developed among tax advisers who focused on the anomalous problem of helping clients who had assiduously saved for retirement avoid taking distributions from their pension arrangements while still alive.[15]

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9. *See infra* Part I.A.

10. Of course, the same power granted to the Treasury Department under I.R.C. § 7805(a) can produce significant *complexity* as well. *See infra* Parts I.A. and C.

11. *See* Prop. Treas. Reg. § 1.401(a)(9), *supra* note 6.

12. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, 52 Fed. Reg. 28,070 (July 27, 1987).

13. Respecting individual retirement accounts, I.R.C. § 408(a)(6) specifically incorporates by reference the minimum distribution requirements of I.R.C. § 401(a)(9).

14. One of these experts is Boston attorney Natalie Choate, who frequently speaks on the minimum distribution requirements at the University of Miami Institute on Estate Planning. She is the author of a popular book on the subject. NATALIE CHOATE, LIFE AND DEATH PLANNING FOR RETIREMENT BENEFITS (3d ed. 1999).

15. Many of these clients are or were owners of small businesses that created wealth for them outside of their pension arrangements. In some cases, business owners continue to work and draw salaries from their businesses beyond their reaching age 70 ½, yet must commence retirement distributions because persons owning more than five percent of an employer cannot take advantage of I.R.C. § 401(a)(9)(C)(i)(II)

Of particular concern were portions of the 1987 proposed regulations that permitted maximum deferral of retirement plan distributions only if the person owning the plan account designated a beneficiary by the statutorily imposed "required beginning date."[16] Owners of retirement benefits who began their eighth decade of life without making a formal beneficiary designation in a timely manner would have to draw out larger annual payments, consistent with their own single life expectancies.[17] They could not take payments consistent with a joint life expectancy.[18]

Larger annual payments, of course, meant a larger annual federal income tax obligation. The penalty for ignoring mandatory distributions, a fifty percent excise tax on monies improperly retained,[19] generally assured that a benefit owner who missed the opportunity to spread out distributions over a longer period had to focus on other tax savings devices that might mitigate the effect of larger retirement plan distributions.[20] Failure to designate a beneficiary by the statutory required beginning date was a common oversight that inordinately complicated the tax planning of thousands of taxpayers who survived beyond the age of 70 ½.[21]

The 1987 proposed regulations imposed further complications upon retirement plan distributees regardless of whether they had the foresight to make a timely beneficiary designation. Once the required beginning date was reached, distributees had to select one of three ways to receive required minimum distributions from a retirement plan; they could choose either a term certain calculation, a "recalculation" approach, or a hybrid calculation method.[22] Failure to select a calculation method could invoke a default method set out in the retirement plan or otherwise chosen by the trustee of the

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(allowing deferral of distributions to the year of retirement for workers who have passed age 70 ½). *See* I.R.C. § 401(a)(9)(C)(ii)(I) (West 2002).

16. I.R.C § 401(a)(9)(C) and *supra* note 15.

17. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, D-3(a), 52 Fed. Reg. 28,070, 28,079 (July 27, 1987).

18. *See id.*

19. *See* I.R.C. § 4974(a) (West 2002).

20. For example, the distributee might focus on transferring non-pension income producing assets to family beneficiaries while minimizing the impact of estate, gift, and generation-skipping taxes imposed under Subtitle B of the Internal Revenue Code. In other instances, a distributee might attempt to generate operating loss deductions to offset income recognition from minimum distributions from a retirement plan while struggling to avoid such Code pitfalls as the passive activity loss limitations of I.R.C. § 469.

21. *See generally* Prop. Treas. Reg. § 1.401(a)(9)-1, D., 52 Fed. Reg. 28,070, 28,078 (July 27, 1987), "Determination of the designated beneficiary," respecting the technical complexities that arose from the beneficiary selection requirement.

22. *See* Prop. Treas. Reg § 1.401(a)(9)-1, E. 52 Fed. Reg. 28,070, 28,080 (July 27, 1987), "Determination of Life Expectancy." E-1 references both the term certain calculation (based on the employee's attained age in the year the employee reaches age 70 ½) and the "recalculation" approach (elaborated upon in E-6 through E-8). E-7(b) refers to the hybrid possibility, by which the life expectancy of one spouse may be recalculated even though that of the other spouse is not.

retirement fund.[23] These methods could easily produce widely varying results over a retiree's remaining life and beyond during the period when a beneficiary might enjoy continuing distributions.[24] Often a person reaching the required beginning date had to make an uninformed guess about future events in order to select the method that would produce the most desirable pattern of minimum required distributions.[25]

Election possibilities, as well as other features of the 1987 proposed regulations,[26] gave tax advisers an ample source of billable hours and complicated the lives of all elderly taxpayers who desired maximum flexibility in balancing current income needs with tax and estate planning considerations that affected their beneficiaries very directly.[27] Amazingly, the architects of these proposed regulations set forth the following statement in the preamble to the 1987 proposal:

> [t]he Service is concerned that the regulations implementing the required distribution rules for qualified plans, IRAs, and tax-sheltered annuity contracts not cause practitioners, plan and IRA administrators, and taxpayers unnecessary difficulty. These statutory rules reflect an important policy objective. However, due to the inherent difficulty of the statutory rules, we believe that these regulations should provide as certain and simple rules as possible . . . the proposed regulations

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23. Prop. Treas. Reg § 1.401(a)(9)-1, E-7(a), 52 Fed. Reg. 28,070, 28,082 (July 27, 1987).

24. Under a term certain calculation each succeeding year's minimum distribution is determined by dividing the participant's benefit balance by the life expectancy originally determined at the time of the first minimum distribution less one year for each annual period lapsed. Thus, if at the required beginning date the participant's life expectancy was fifteen years, the divisor for the first annual distribution would be fifteen, decreasing to fourteen for the second distribution, thirteen for the third, etc. Recalculation of life expectancy would produce a more slowly decreasing divisor, since even after a participant outlives life expectancy as originally determined, a new life expectancy still exists for each succeeding year. *See* Treas. Reg. § 1.72-9, tbl. I (as amended in 1995).

25. Guessing incorrectly that a participant might live beyond life expectancy could lead to accelerated distribution of a plan account under the recalculation method, since the recalculated life expectancy of a participant upon death is reduced to zero. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, E-8(a), 52 Fed. Reg. 28,070, 28,082 (July 27, 1987).

26. A particularly difficult feature of the 1987 proposed regulations is the "[m]inimum distribution incidental benefit requirement," which generally increases minimum distributions when a designated beneficiary is substantially younger than the plan participant. *See* Prop. Treas. Reg § 1.401(a)(9)-2, 52 Fed. Reg. 28,070, 28,078 (July 27, 1987).

27. Sometimes beneficiaries would face both an estate tax imposition, as a result of inclusion of retirement accounts in a decedent's gross estate under I.R.C. § 2039 and accelerated income taxation under the minimum distribution rules. *See supra* note 25. The combination of both taxes might leave a beneficiary with only a minor fraction of the pre-death account balance.

> attempt to simplify compliance with the required distribution rules in several ways . . . .[28]

Fourteen years later the Treasury Department demonstrated that further simplification of the minimum distribution rules was indeed possible.[29]

B. The Second Attempt to Regulate Retirement Plan Minimum Distributions

The 2001 proposed regulations under I.R.C. § 401(a)(9)[30] eliminated the need to designate a beneficiary by the required beginning date,[31] eliminated the choice of methods for calculating minimum required distributions,[32] and set forth a user-friendly uniform table for determining quickly the minimum distribution for any attained age of a distributee.[33]

As well, the new regulations update the mortality assumptions that underlie the minimum distribution rules,[34] permit those already receiving minimum required distributions to correct past mistakes,[35] and allow account owners to choose beneficiaries solely for nontax reasons rather than to stretch out retirement plan distributions to the maximum possible extent.[36] To assist taxpayers even further, the new regulations require financial institutions holding retirement funds to give minimum required distributions information to account owners showing the dollar amount to be distributed each year once the required beginning date has passed.[37]

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28. Preamble, Prop. Treas. Reg. § 1.401(a)(9), 52 Fed. Reg. 28,070, 28,071 (July 27, 1987) ("Simplification of Required Distribution Rules").

29. *See* Prop. Treas. Reg. § 1.401(a)(9), 66 Fed. Reg. 3928, 3935 (Jan. 17, 2001).

30. *Id.* finalized by T.D. 8987, 2002-19 I.R.B. 852, and now cited as Treas. Reg. § 1.401(a)(9) (2002).

31. Treas. Reg. § 1.401(a)(9)-4, A-4(a) (2002) (In order to be a "designated beneficiary," an individual need only be a beneficiary as of the participant's date of death.). Contrast Prop. Treas. Reg. § 1.401(a)(9)-1, D-3(a), 52 Fed. Reg. 28,070, 28,079 (July 27, 1987), which requires designation of a beneficiary by the "required beginning date" of I.R.C. § 401(a)(9)(C).

32. Treas. Reg. § 1.401(a)(9)-5, A-4(a) (2002) now generally provides that minimum distribution amounts derive from a "Uniform Lifetime Table" set out in A-2 of Treas. Reg. § 1.401(a)(9)-9 (2002).

33. Treas. Reg. § 1.401(a)(9)-5, A-1(a) (2002) indirectly instructs a distributee to divide the plan account balance for a distribution year by the applicable divisor taken from the Uniform Lifetime Table. *See supra* note 32.

34. *See* Treas. Reg. § 1.401(a)(9)-9, A-4 (2002).

35. For example, if a participant failed to designate a beneficiary by the required beginning date as required under the old rules to protract distributions to a survivor, the participant can now extend the distribution period by simply designating a beneficiary at any time prior to death. *See supra* note 31.

36. The fixed divisors of the Uniform Lifetime Table of Treas. Reg. section 1.401(a)(9), A-2 permit a participant to name an *older* beneficiary without detrimentally shortening the distribution period during the participant's lifetime.

37. I.R.S. Notice 2002-27, 2002-18 I.R.B. 814 (2002).

The response to these new rules from practitioners and tax commentators was immediately favorable. One tax materials editor remarked in a "sample client letter":

> I am writing to tell you that the IRS has simplified and liberalized the rules that determine the minimum annual distribution that must be withdrawn from . . . retirement accounts. In general, you can withdraw less each year under the revised rules than you did under pre-existing IRS guidance. For those looking to withdraw the rock-bottom minimum from their retirement plan accounts, the revised rules provide a lower tax bill, a longer-lived tax shelter for the family, and potentially larger payouts for the owner's beneficiaries . . . . These rules replace an incredibly complex labyrinth of rules where post-death payouts depended on the payout method chosen by the account owner.[38]

The Internal Revenue Service itself describes the new rules for required minimum distributions in similar glowing terms at its internet site:

> [t]he dawn of a new millennium has brought a significant simplification of rules for required minimum distributions from qualified plans, IRAs, section 403(b) annuities, and section 457 deferred compensation plans. Not only are the rules less complex, but they reduce the amount of distributions required to be taken each year for the majority of employees and IRA owners . . . . The 2001 Proposed Regulations provide a simple, uniform table that most employees can use to determine minimum distributions during their life . . . . The 2001 Proposed Regulations also provide greater flexibility in choosing a beneficiary . . . .[39]

A new highly celebrated regulatory face now looks down on those who must deal with mandatory retirement plan distributions in benign contrast to the old countenance. Yet the old face still scowls at taxpayers and their advisers in the realm of tax-favored retirement savings arrangements.[40]

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38. *¶ 1300, Revised Required Minimum Distribution Rules for Qualified Plans and IRA's Client Letters*, RIA FED. TAX. COORDINATOR, May 9, 2002, at 11, 020L-3,4, http://www.checkpoint.riag.com/servlet/com.tta.checkpoint.servlet.CPJSPServlet?jsp=%2F.

39. Internal Revenue Service publication, "The Digital Daily," *at* http://www.irs.gov/irs/display/0,,il%3D46%26 genericId%3D6944,00.html (under the headings "Retirement" and "New Rules for Required Minimum Distributions").

40. The proposed and final regulations under I.R.C. § 401(a)(9) deal with a problem that affects taxpayers directly because of the penalty tax of I.R.C. § 4974 imposed against amounts that should have been distributed but were not. The problem also directly affects employers that sponsor retirement plans under the general qualification scheme of I.R.C. § 401(a), since each element of the scheme must be satisfied

C. *Unfinished Regulatory Business for Retirement Arrangements*

Although retirement plan participants and their advisers now have an easier task when dealing with mandatory distributions, employers who sponsor qualified retirement arrangements and their consultants who implement plan designs still struggle with a morass of regulatory pronouncements that govern the prohibition against implementing a plan that inordinately favors highly compensated employees over rank and file workers.[41] In 1993, the Treasury Department issued "final" regulations[42] to clarify fully the terse but vague nondiscrimination standard put forth in I.R.C. § 401(a)(4).[43]

The tortured implementation of these rules to prevent economic discrimination against nonhighly compensated plan participants is accurately described by one bewildered qualified plans consultant:

> [The 1993 regulations] gave us 639 pages of very complicated rules to digest . . . . In the 'good ol' days' prior to the nondiscrimination [regulations], we lived in an environment where discrimination was a 'facts and circumstances' test . . . . For many years [prior to the regulations], this was how we operated: Apply to the IRS for a determination letter, and let's see if we passed the smell test! . . . The IRS itself was not all that comfortable with the smell-test approach. So, they decided to issue comprehensive, interrelated rules that would provide a 'cookbook' approach to deciding if a plan was non-discriminatory . . . . We could now 'flunk' the smell test, but as long as our plan met the rules of the cookbook, it just didn't matter how it smelled.[44]

Like the authors of the 1987 proposed regulations on mandatory plan distributions,[45] the drafters of the 1993 nondiscrimination regulations thought

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in order for both participants and employers to enjoy the various tax benefits accorded qualified plans, including immediate deductibility of employer contributions under I.R.C. § 404 and employment tax relief under I.R.C. § 3121(a)(5)(A). The next section of this article deals with a different plan qualification issue involving possibilities for plan structures to effect economic discrimination that favors highly compensated participants. The burden of this issue tends to fall directly on sponsoring employers, who must design and operate their plans in a manner that avoids the discrimination prohibited under I.R.C. § 401(a)(4).

41. The definition of "[h]ighly compensated employee" appears in I.R.C. § 414(q).

42. *See* Treas. Reg. § 1.401(a)(4) (1993).

43. I.R.C. § 401(a)(4) simply states that an employer will have a qualified plan (absent failure to meet any other requirement of I.R.C. § 401) "if the contributions or benefits provided under the plan do not discriminate in favor of highly compensated employees (within the meaning of § 414(q))."

44. Lawrence C. Starr, *Small Business Plans: 401(a)(4) and Cross-Testing: The Sequel*, 8 J. PENSION BENEFITS 45 (2000).

45. *See supra* note 28 and accompanying text.

they had greatly simplified a key regulatory problem. Instead, the authors of the new nondiscrimination rules created regulatory complexity that led to unintended consequences—this time to the detriment of the regulators *and* an entire class of retirement plan participants. The above-quoted practitioner again cuts to the heart of the matter:

> I had argued very early on that the IRS had not realized what they had done. They provided us with an enormously complex, interrelated web of rules comprising specific mathematical tests and bright-line determinations of what was and what was not acceptable. Pass the tests, and you are ok, flunk the tests, and you are not ok. It was very simple now (though the application of the rules was anything but simple): You're either ok or you're not ok, and everyone knows what the rules are. From the IRS standpoint, they had eliminated the inherent unfairness of the smell test. What they also provided to the practitioners was a cookbook that, instead of being titled *How Not to Discriminate*, could be titled *How to Legally Discriminate in Favor of Highly Compensated Employees*.[46]

Governmental recognition that the nondiscrimination regulations had indeed been set forth in so complex a manner that they actually fostered discrimination to the detriment of rank and file participants came in the form of yet additional regulations made final by the Treasury Department in 2001.[47] These additional regulations attacked an outgrowth of the 1993 regulations known as "new comparability plans."[48] In order to prevent plan designers from setting up classes of contribution allocation rates that could result, for example, in highly compensated employee allocations of up to twenty percent of compensation while nonhighly compensated employees might receive allocations of only three percent of compensation,[49] the new regulations require that plan designs meet a "minimum allocation gateway."[50]

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46. Starr, *supra* note 44, at 45-46.

47. *See* Treas. Reg. § 1.401(a)(4)-8 (2002).

48. New comparability plans are defined contribution plans that, contrary to the basic edict of I.R.C. § 401(a)(4), permit substantially higher contribution allocation rates for highly compensated employees than for nonhighly compensated employees. These allocation rate disparities ostensibly derive from a concept known as "cross-testing" permitted generally under Treas. Reg. § 401(a)(4)-8. Cross-testing allows greater contribution allocation rates for older participants (often highly compensated employees) under an actuarial funding approach normally used in defined benefit pension plans.

49. *See Proposed Regs Would Limit Cross-Testing for New Comparability Plans*, CCH FED. TAX WKLY., Oct. 12, 2000, at ¶ 5, http://tax.cch.com/primesrc/bin/highwire.dlla?=dd&DI=15CFFCA8FCA99545FEC9cchnar.a.p.

50. Treas. Reg. § 1.401(a)(4)-8(b)(1)(B)(3) (2002).

In effect, the new regulations add another layer of complexity to nondiscrimination testing for qualified plans,[51] do not remedy the underlying complexity of the 1993 final regulations,[52] and fail to dispel doubts about the core policy of the nondiscrimination rule as a fundamental part of the Internal Revenue Code's scheme for retirement plan qualification.[53] If the nondiscrimination concept is worth protecting, it should invoke a streamlined regulatory response that assures a greater degree of certainty, simplicity, and user-friendliness than the 1993 regulations have displayed.[54] The new regulations addressing the potential abuses of "new comparability plans" illustrate that nondiscrimination rules remain a work in progress—still too complex and inefficient—much like the mandatory distribution rules prior to January of 2001.[55]

II. IMPLEMENTING SIMPLICITY

A. Eliminating Facts and Circumstances Standards—Only a Start Toward Simplicity

Throughout the Internal Revenue Code, Congress set forth concepts and standards, like the nondiscrimination standard of I.R.C. § 401(a)(4), that beg for regulatory interpretation to convert vagueness into a workable set of sub-rules for the guidance of taxpayers.[56] Frequently, the interpretive regulatory approach taken by the Treasury Department will rely upon a "facts and

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51. Treas. Reg. § 1.401(a)(4)-8(b) (2001) approximately tripled in word volume following the changes necessary to address the potential abuses of new comparability plans. Most telling about the added complexity of the new regulations are the examples set out at Treas. Reg. § 1.401(a)(4)-8(b)(1) (viii) (2002).

52. Even a cursory review of the dense and bulky contents of Treas. Reg. § 1.401(a)(4)-1 through 1.401(a)(4)-13 (as amended through 2001) will reveal that a nonexpert reading these rules would have no hope of understanding them.

53. For a critique of the nondiscrimination rule in the context of employer choices to use potential plan contributions for direct business investments, see Kovach, *Toward Equalization of the Personal Retirement Savings Prerogatives of Small Business Owners and Their Employees*, 31 LOY. U. CHI. L.J. 369, 384-87 (2000).

54. For example, regulators could borrow the "permitted disparity" concept from I.R.C. § 401(a)(l) to replace discrimination testing with a uniform allocation allowance that reflects both Social Security contribution disparities *and* age-weighting pursuant to a table that reflects a sliding scale based on a participant's age.

55. *See supra* Part I.A.

56. Sometimes Treasury regulations specifically identify a rule as involving an analysis of the facts and circumstances of each case, but frequently the vagueness of a rule itself is sufficient identification. *See, e.g.*, Treas. Reg. § 1.410(b)-4(c)(3)(ii) (1992) (involving nondiscriminatory classifications pertaining to participation coverage under qualified retirement plans); Treas. Reg. § 1.302-2(b) (1997) (pertaining to whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under I.R.C. § 302(b)(1)).

circumstances" analysis of a particular taxation standard.[57] Although Treasury regulations often contain hypothetical examples that assist a taxpayer struggling to apply a standard to a potentially unique situation,[58] facts and circumstances determinations ultimately become highly subjective and thus can lead to widely varying results.[59] Accordingly, working with facts and circumstances tests produces a great deal of compliance complexity as taxpayers attempt to grope their way to the outer edges of permissibility.[60]

For this reason, advocates for simplification of our income taxation system frequently applaud administrative efforts to convert facts and circumstances rules into more precise formulations that introduce greater objectivity into the compliance process.[61] Unfortunately, regulators sometimes string together too many precise formulations into one regulatory mass that itself produces complications that rival those resulting from the sin of subjectivity.[62]

Respecting the voluminous nondiscrimination regulations of 1993,[63] not only did the sheer weight of formulaic expression require considerable expertise to unravel,[64] but the volume of rules also allowed room for interpretations that, even to taxpayer representatives, appeared to thwart the

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57. *See supra* note 44 and accompanying text respecting interpretations of the nondiscrimination rule of I.R.C. § 401(a)(4) prior to that provision's 1993 regulations.

58. *See, e.g.*, Treas. Reg. § 1.410(b)-4(c)(5) (1992), which sets forth six examples illustrating the nondiscriminatory coverage issue referenced in *supra* note 56.

59. Under the old "facts and circumstances" view of I.R.C. § 401(a)(4), the same retirement plan design might be submitted for an IRS determination letter in two different locations with acceptance by one examiner but rejection by another. *See supra* note 44 and accompanying text.

60. The difference in results indicated in the preceding note often depended on the persuasiveness (and perhaps likability) of the taxpayer's representative submitting the plan.

61. Occasionally, Congress will alter the Internal Revenue Code in a similar manner. *See infra* notes 90-93 and accompanying text. In particular, determining "salvage value" was a difficult facts and circumstances undertaking under the old statutory scheme for depreciation allowances.

62. Note the references to the volume of new rules in the quote in the text for note 46 *supra* and the parenthetical reference in the quote in the text for note 46 *supra*. That the new rules are complex but understandable to the person quoted tells us that he is indeed an expert in retirement plan design. The Treasury Department clearly drafted those rules with such experts in mind, not any hapless employer that might attempt self-help in designing a retirement plan. *See infra* part III.A. of this article respecting the conclusion that direct comprehension for taxpayers themselves would serve as a useful standard for simplifications of tax rules.

63. Treas. Reg. § 1.401(a)(4)-1 through 13 (1993).

64. I.R.S. Publication 560, *Retirement Plans for Small Business* states laconically at page 11: "If you prefer, you can set up an individually designed plan to meet specific needs. Although advance IRS approval is not required, you can apply for approval by paying a fee and requesting a determination letter. You may need professional assistance for this." Employers who might wish to optimize retirement plan designs under the nondiscrimination regulations would agree that the last sentence of this quote represents the height of understatement.

very purpose of the nondiscrimination concept.[65] Avoidance of the prior facts and circumstances subjectivity of the nondiscrimination concept simply traded one kind of complexity and potential abuse for another.

The minimum distribution regulations of 1987, by contrast, never really had to address the subjectivity problem associated with facts and circumstances tests.[66] Nonetheless, the 1987 regulations provided seemingly objective interpretative guidance that, like the 1993 nondiscrimination regulations, required inordinate technical expertise to understand and frequently resulted in widely disparate consequences for taxpayers.

At the same time the 1993 nondiscrimination regulations led taxpayers through a labyrinth of safe harbors,[67] cross-testing computations,[68] and participant classification schemes,[69] the 1987 minimum distribution regulations bewildered their victims with beneficiary election timing requirements,[70] distribution computation elections,[71] and incidental benefit adjustments.[72] The great volume of "cookbook" nondiscrimination rules could not offer so complete an array of recipes that would avoid, just seven years after their promulgation, a significant reworking to address the "new comparability plan" debacle.[73] The declaration of simplification in the preamble to the 1987 minimum distribution regulations[74] did not convince taxpayers and their advisers that the Treasury Department was unable to implement further simplification. In each case, the ugly countenance of regulatory complexity produced compliance instability that prompted new administrative responses.

B. Simplicity and Generosity

Over twenty years ago, the Treasury Department engaged in a regulations project that so completely failed that regulators were forced to abandon determinable standards and return to a vague, abuse-laden facts and circumstances standard originally set forth in the Internal Revenue Code to

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65. *See supra* note 46 and accompanying quote with its "How to Legally Discriminate" comment.

66. The problem respecting the minimum distribution rules of I.R.C. § 401(a)(9) was how to interpret a Code provision that was objective on its face but too incomplete to permit certainty of application. The new minimum distribution rules of Treas. Reg. §1.410(a)(9) (2002) supply needed detail for a standard that is not intrinsically vague, as is the nondiscrimination standard of I.R.C. § 401(a)(4).

67. *See, e.g.*, Treas. Reg. § 1.401(a)(4)-2(b) (1993).

68. *See* Treas. Reg. §1.401(a)(4)-8 (1993).

69. *See, e.g.*, Treas. Reg. § 1.401(a)(4)-10 (respecting nondiscrimination testing of *former* employees).

70. *See supra* note 31.

71. *See supra* note 22 and accompanying text.

72. *See supra* note 26.

73. *See infra* Part I.C.

74. *See supra* note 28 and accompanying text.

curb a special problem involving corporate taxation.[75] Internal Revenue Code § 385 exists to assist taxpayers and tax enforcers in distinguishing when a debt instrument issued by a corporation bears sufficient characteristics of an equity position to result in its reclassification as a stock instrument for tax purposes.[76]

Because a corporate taxpayer can deduct interest payments but not dividends, using debt rather than equity obligations when capitalizing a closely-held corporation enhances the income tax posture of the entity.[77] Because a shareholder who minimizes shareholdings in favor of advancing money to the entity substitutes debt for larger equity values, repayment of principal on the debt allows for a tax-free retransfer of value back to the shareholder-creditor in lieu of later income recognition upon receipt of dividends or compensation.[78] Overall, using debt instruments to represent value transferred by a shareholder to a corporation is a significantly more tax efficient device than equity funding. Consequently, a form versus substance issue surfaces immediately upon incorporation of a closely-held entity if shareholders use debt capitalization too aggressively.

The legislative response to this issue is terse, consisting of a listing of five considerations "among other factors" unspecified: (1) the nature of the payment promise; (2) subordination of shareholder debt to other corporation indebtedness; (3) the entity's debt to equity ratio; (4) whether the debt is convertible into stock; (5) proportionality of insider debt to confirmed shareholdings.[79] In effect, I.R.C. § 385 leaves the issue to a classical facts and circumstances test while presenting only a few categories of factors to consider in making debt-equity determinations. Congress clearly hoped that the debt-equity problem would lead to more definite regulatory standards, since I.R.C. § 385 itself, uncharacteristically for Internal Revenue Code sections in general, specifically authorizes the Treasury Department to issue clarifying regulations.[80]

Eventually, the Treasury Department did issue a comprehensive but complex set of proposed regulations containing a number of bright-line

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75. *See* Prop. Treas. Reg. § 1.385, 45 Fed. Reg. 86,438 (Dec. 31, 1980).

76. I.R.C. § 385(b)(1)-(5) nonexhausively lists five "factors" that regulations may include to develop rules for distinguishing a debtor-creditor relationship from a corporation-shareholder relationship. For example, I.R.C. § 385 (b)(3) lists the ratio of debt to equity of the corporation as one of these five key factors, and the proposed regulations dutifully attempted to place reasonable limitations on debt to equity ratios in Prop. Treas. Reg. § 1.385-6(f)(4), 45 Fed. Reg. 86,438, 86,438-54 (Dec. 31, 1980).

77. *See* I.R.C. § 163 (West 2002).

78. Return of the principal of a debt does not constitute income under the "undeniable accessions to wealth" standard of *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

79. I.R.C. § 385(b)(1)-(5) (West 2002).

80. I.R.C. § 385(a) (2002).

approaches to the debt-equity classification conundrum.[81] The response of the tax practice community to these proposed regulations was swift and strident.[82] The Treasury Department withdrew the proposed regulations and to this date the explicit reference to regulatory guidance contained in I.R.C. § 385 has produced no regulatory product.[83] Tax practitioners and administrators still struggle with the original facts and circumstances approach embodied directly in I.R.C. § 385.[84]

The proposed regulations under I.R.C. § 385 failed because taxpayer representatives overwhelmingly thought them *both* too complex and ungenerous.[85] Simplification of abstruse tax concepts alone will not engender public acceptance if taxpayers believe they are substantially advantaged under existing vague standards by comparison. Although the retirement plan nondiscrimination regulations are demonstrably more complex than were the ill-fated proposed regulations issued under I.R.C. § 385, the tax practice community readily accepted the nondiscrimination regulations because they proved generous to plan sponsors wishing to minimize contributions for rank and file participants while maximizing contributions for highly compensated employees.[86] Similarly, although the new minimum distribution regulations under I.R.C. § 401(a)(9) remove a great deal of complexity, the enthusiasm with which practitioners have embraced them results as much from their generosity in permitting greater income recognition deferral as from their user-friendliness.[87]

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81. Prop. Treas. Reg. § 1.385, 45 Fed. Reg. 86,438, 86,438-59 (Dec. 31, 1980).

82. *See, e.g.*, the criticism expressed against the I.R.C. § 385 regulations in Jack S. Levin & Stephen S. Bowen, *The Section 385 Regulations Regarding Debt Versus Equity: Is the Cure Worse Than the Malady?* 35 TAX LAW. 1, 40-41 (1981).

83. The Treasury Department's withdrawal of the I.R.C. § 385 regulations became effective August 5, 1983. T.D. 7920, 1983-2 C.B. 69.

84. This struggle is somewhat constrained by I.R.C. § 385(c)(1) (West 2002), which provides: "The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary)."

85. For commentary on the "110 single-spaced pages" of the regulations and their contribution to an overall detrimental complexity of the law in general, see Bayless Manning, *Hyperlexis and the Law of Conservation of Ambiguity: Thoughts on Section 385*, 36 TAX LAW. 9 (1982). Mr. Manning definitely would not like the even more voluminous nondiscrimination regulations issued under I.R.C. § 401(a)(4).

86. *See supra* note 46 and accompanying text.

87. *See supra* note 39 and accompanying text quoting the I.R.S.: "Not only are the rules less complex, but they reduce the amount of distributions required to be taken each year for the majority of employees and I.R.A. owners."

C. *Other Paths to Tax Simplification*

Both Congress and the Internal Revenue Service have implemented a variety of ways to simplify tax rules while giving a nod of generosity to taxpayers. Prominent examples of legislative simplification exist respecting portions of the Code that deal with depreciation allowances granted to the owners of remunerative assets having a determinable useful life. Prior to 1981, I.R.C. § 167 governed these allowances.[88] Voluminous Treasury regulations[89] set out a complex scheme that parsimoniously permitted owners of business assets to deduct the cost of their assets piecemeal over an extended period of time technically designed to correspond with the wearing out or obsolescence of such properties.[90]

I.R.C. § 168 significantly simplified the old depreciation system while allowing more generous depreciation deductions.[91] The new system introduced timing conventions,[92] simplified and shortened depreciation periods,[93] increased the size of deductions in the earlier years of an asset's use,[94] and eliminated a special valuation problem resulting from the former system's disallowance of any deductions to the extent of an asset's "salvage value."[95]

At about the same time Congress streamlined the entire depreciation system, they also permitted many small businesses to avoid struggling with any kind of attenuated tax recovery of asset costs by implementing the so-called "bonus depreciation" concept of I.R.C. § 179.[96] Within defined limits, qualifying owners of newly acquired business assets could deduct the entire cost of such assets immediately upon acquisition and use.[97] I.R.C. § 179 at once represents a substantial elimination of tax complexity and a generous tax savings for small business owners.[98]

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88. I.R.C. § 167 still applies to depreciation allowances not covered under I.R.C. § 168. *See* I.R.C. § 168(a) (West 2002).

89. *See* Treas. Reg. § 1.167(a)-1 (1980 and as subsequently amended).

90. *Id.*

91. I.R.C. § 168 introduced the "[a]ccelerated cost recovery system" of depreciation allowances.

92. *See* I.R.C. § 168(d) (West 2002).

93. *See id.* § 168(c).

94. *See id.* § 168(b).

95. *See id.* § 168(b)(4).

96. I.R.C. § 179(a) allows taxpayers to elect to treat certain depreciable asset costs as immediately deductible expenses not chargeable to capital accounts subject to prolonged depreciation deductions over a period of years.

97. See the dollar limitations of I.R.C. § 179(b).

98. I.R.C. § 179 is elective. I.R.C. § 179(a) (West 2002). Thus, taxpayers who have little taxable income in the year they acquire § 179 properties can defer deductions against the cost of such assets via the regular allowance system of I.R.C. § 168, potentially matching deductibility with higher taxable income in future years. *See* I.R.C. §§ 168 & 179 and accompanying regulations (West 2002). This is another aspect

Presumably, Congress has greater power to effect tax simplifications than agencies of the executive branch of government.[99] Yet even the Internal Revenue Service, subordinate to the Treasury Department granted legislative grace to draft a wide variety of interpretive regulations,[100] has assumed broad power to issue administrative promulgations that can potentially simplify abstruse rules and concepts of the Internal Revenue Code.[101]

Among many and varied administrative concessions, the Internal Revenue Service has unilaterally simplified the very complex uniform capitalization rules of I.R.C. § 263A as applied to certain producers of creative works,[102] greatly facilitated the deductibility of costs associated with many kinds of computer software,[103] brought greater certainty to income recognition issues faced by taxpayers who incorporate a business while transferring to the new entity both property and services,[104] allowed small businesses greater access to the easy-to-use cash method of tax accounting,[105] and relieved small corporations from the duty to provide "book reconciliations" on their tax returns.[106] In each of these examples, the Internal Revenue Service interpreted applicable provisions of the Internal Revenue Code in a manner similar to that evident in those Treasury regulations that both simplify Code interpretations and loosen revenue exactions at the same time.[107]

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of the provision's generosity to taxpayers.

99. An interesting question of administrative law is whether the cost recovery scheme of I.R.C. § 168 could, in effect, have been implemented by the Treasury Department simply by abandoning Treas. Reg. § 1.167 and replacing it with a new set of regulations that contained all the depreciation features now set out in I.R.C. § 168.

100. I.R.C. § 7805(a) (West 2002).

101. *See supra* note 1.

102. *See* Notice 88-62, 1988-1 C.B. 548, 548-51, which "provides guidance to certain authors, photographers, artists, and other similarly situated persons" for determining when the expenses of their activities must be capitalized into their creations rather than immediately deducted.

103. *See* Rev. Proc. 2000-50, 2000-2 C.B. 601, 601-02, which provides guidelines respecting the deductibility of costs incurred in the development of computer software.

104. *See* Rev. Proc. 77-37, 1977-2 C.B. 568, 568-71.

105. *See* Rev. Proc. 2002-38, 2002-18 I.R.B. 815.

106. I.R.S. News Release IR-2002-48 (April 10, 2002).

107. Thus, the delegation of interpretive authority passed by Congress to the Treasury Department under I.R.C. § 7805(a) has led to a further delegation from the Treasury Department to the Internal Revenue Service. The mission of the Internal Revenue Service, as stated at the beginning of every volume of the Internal Revenue Cumulative Bulletin, is to "[p]rovide America's taxpayers top quality service by helping them *understand* and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." [emphasis added] 2001-1 C.B. ii. Consequently, the delegation of interpretive authority to the Internal Revenue Service should substantially promote understanding through rule simplification.

III. RECONCILING THE COMPETING INTERESTS OF SIMPLICITY AND COMPLEXITY

A. The Internal Revenue Service Versus Practitioners

Both those who administer the tax laws and practitioners who represent taxpayers have ostensible reasons for tolerating a great deal of complexity in our taxation systems. After all, a large volume of complicated tax rules promotes greater job security for both groups of experts.[108] From a less cynical point of view, an objective policy observer might acknowledge that tax complexity results naturally from each group of expert's dutiful attempts to advance the fundamental interests of their constituencies within a larger political system that honors adversarial determinations.[109] In order to maximize revenue collections and prevent aggressive misinterpretations of revenue laws, tax administrators will desire detailed promulgations that leave little room for taxpayers to wiggle out of their presumed obligations to pay appropriate taxes.[110] In order to prevent their clients from paying any greater amount of taxes than absolutely necessary, tax practitioners will push for individualized interpretive exceptions to revenue laws that favor some taxpayers over others.[111] In an adversarial system, such discrete interests produce ever increasing complexity.[112]

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108. An indirect indication of the increasing demand for tax professionals is the proliferation in the last several years of academic programs, in both law and business schools, that lead to a masters degree in taxation studies.

109. Frequent complaints that America has too many lawyers and too much litigation compared with other "first world" countries bespeak our cultural tendency to elevate advocacy over consensus in the resolution of public issues.

110. The retirement plan nondiscrimination regulations discussed *supra* in Part I.C. of this article are an example of how a regulations project did indeed create "wiggle room" despite vast detailed content.

111. Presumably, Rev. Proc. 2000-50, *see supra* note 103 and accompanying text, represents an administrative response to placate a group of taxpayers who were deliberately slighted under the research credit provisions of I.R.C. § 41, which specifically denies the credit to taxpayers who engage in nontechnological research. I.R.C. § 41(d)(4)(G) (West 2002). *See also* Treas. Reg. § 1.174-2 (a)(3)(vii) (1960 and as subsequently amended), which denies immediate deductibility for expenses from "[r]esearch in connection with literary, historical, or similar projects."

112. Despite the huge volume of text comprising the Internal Revenue Code, Treasury Regulations, and various promulgations issued by the Internal Revenue service, reported decisions of courts from litigated tax controversies still fill shelf upon shelf of volumes in law libraries. One tax publication states, "Since 1913, when the first income tax under the Sixteenth Amendment was enacted, the federal tax system has continually grown in complexity and impact. Paralleling this tremendous expansion, [our publication] has perfected its contents, organization, and approach." CCH Standard Federal Tax Reports ¶ 1, at 10,005 (2002). Litigation, as much as administrative growth, accounts for the "tremendous expansion" of our tax systems.

Yet both groups of tax experts suffer substantial inconveniences, expense, and confusion as a result of escalating tax complexity—to a point that leads them to at least a modest consensus on the mutual advantages of tax simplification.[113] Presumably, both the average Internal Revenue Service examiner and the typical taxpayers' representative have an aversion to rising levels of tax complexity that outpace their abilities to absorb a growing volume of tax rules or comprehend the more arcane interactions of those rules. At some point, increasing complexity stops being a professional challenge that can lead to career satisfaction and starts to become a frustrating aggravation that portends error, uncertainty, and disdain for the work at hand.[114]

This complexity threshold has the potential to alter the normally adversarial relationship between revenue defenders and practitioners in favor of a more cooperative relationship built upon the consensus that complexity in our taxation system must not escalate to a level that brings inordinate discomfort to the experts. Thus, both the Internal Revenue Service and the tax practice community expressed great satisfaction and relief upon the issuance of streamlined minimum distribution regulations under I.R.C. § 401(a)(9).[115]

Fortunately for taxpayers themselves, the relief from complexity afforded by the new minimum distribution regulations arguably reaches a level of simplicity consistent with the comfort and comprehension of a layperson who struggles with tax compliance without the aid of professional advice.[116] The retirement plan nondiscrimination regulations, by contrast, seem reasonably workable to knowledgeable practitioners,[117] but certainly would perplex a small business owner not having specific expertise in designing retirement plans.[118] Both sets of regulations meet an "expert's alleviated frustration"

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113. Signs of mutual inconvenience abound. The Internal Revenue Service Manual continues to expand. Employers seeking to fill tax positions increasingly seek applicants already having advanced tax training and education, since on-the-job training becomes increasingly less efficient. Tax libraries can no longer budget the expanding cost of acquiring and maintaining the increasing number of tax publications.

114. Increasing specialization has been one response to such frustration, leading to the somewhat astounding development of recognized experts on a single set of Treasury regulations. *See supra* note 14 and accompanying text.

115. *See supra* Part I.B.

116. The new minimum distribution regulations, Treas. Reg. § 1.401(a)(9) (2002), still contain a great deal of complexity that would bewilder an average taxpayer. Nonetheless, the user-friendly nature of these regulations is apparent from the requirement that plan administrators must now report minimum distribution amounts to distributees. *See supra* note 37 and accompanying text. Thus, in most instances, the distribution rules need not be comprehensible to taxpayers themselves as long as their retirement plan officials understand them.

117. *See supra* notes 44 and 46 and accompanying text.

118. In particular, a layperson would have difficulty understanding the "cross-testing" concept of Treas. Reg. § 1.401(a)(4)-8 (West 2001).

standard of simplicity, but only the minimum distribution regulations come anywhere close to meeting a "layperson's alleviated frustration" standard.

Since both tax administrators and taxpayer representatives offer their services to the public at large,[119] their ideal basis for consensus regarding simplification issues should move from mutual inconvenience of the experts to overall inconvenience of taxpayers per se, including those taxpayers who struggle to understand tax rules without special assistance. No doubt such higher standard for rules simplification would not always materialize without substantial help from Congress.[120] But better regulatory simplification efforts would result if rule makers attempted to satisfy taxpayers directly rather than indirectly through their representatives.[121] Practitioners themselves would more frequently stress simplicity when lobbying for rule changes if they kept in mind the layperson's standard as though it were a professional goal.[122]

B. Uniformity Versus Pluralism

The federal taxation system honors the American virtue of pluralism in so many ways that inherent complexity in the system will continue indefinitely. The Internal Revenue Code affords taxpayers thousands of choices for structuring transactions to produce tax-favored results. For example, several kinds of nonprofit organizations lead to income tax exemptions.[123] Many kinds of retirement savings arrangements produce tax advantages for those who want to defer income recognition to later years.[124] Corporations that wish to transform their existing structures or amalgamate their businesses with those of other entities may choose from a wide variety of reorganization forms that ensure a tax-free transformation.[125] Employers can arrange to compensate their employees with a variety of tax-favored means

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119. The mission of the Internal Revenue Service is not specifically to raise revenue in a hard-nosed manner. *See supra* note 107.

120. Perhaps I.R.C. § 7805(a) should be amended to incorporate a simplification standard into the delegation of rule making authority to the Treasury Department.

121. Some years ago, the Internal Revenue Service attempted to assist taxpayers directly via an "ombudsman" program. In 1996, the I.R.S. replaced the ombudsman with a "Taxpayer Advocate." *See* H.R. REP. NO. 104-506, at 23-27 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1143, 1146-49.

122. As a proposition of professional responsibility for tax professionals, promoting simplification of tax rules would have to be viewed as an important value that complements mere technical expertise.

123. *See generally* I.R.C. § 501(c) (West 2002).

124. *See, e.g.*, I.R.C. §§ 414(i) and (j), 408 (k) and (p), and 401(k), each of which refers to plan classification concepts.

125. *See* I.R.C. § 368(a).

that range from life insurance[126] and health care[127] to discounts on products and services and free parking.[128]

The Internal Revenue Code has grown to resemble a giant supermarket that offers so many varieties of cheese, beer, pickles, etc. that customers cannot find the time to choose rationally among the many products offered and so resort to advertising, habit, or presentation to effect their shopping choices. Of course, nobody would want to shop at a store that only offered one choice per product category, but an abundance of choices starts to lose its appeal at some point, especially if the customer has to start paying for professional assistance to shop wisely.[129]

Tax policy analysts might well wonder whether, for example, taxpayers would seriously object to a statutory reform that would create only one, uniformly regulated cash or deferred retirement savings arrangement in lieu of Section 401(k) plans for one group of sponsoring employers,[130] section 408(p) "SIMPLE" plans for a different group of employers,[131] section 403(b) plans for tax-exempt employers,[132] section 457 plans for governmental employers,[133] and "grand-fathered" section 408(k)(6) "SARSEPs" for yet another group of private employers.[134] On the regulatory front, taxpayers certainly did not rush forward to object to the loss of computational choices resulting from the new minimum distribution regulations. Just as obvious, the preservation of too many computational choices in the 1993 nondiscrimination regulations set up the interpretive mischief of "new comparability" retirement plans necessitating additional regulatory complexities in 2001.[135]

Perhaps a bit more uniformity in the Internal Revenue Code, Treasury regulations, and Internal Revenue Service promulgations would serve to slow down the rapidly increasing complexity of our tax system, reduce taxpayer

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126. *See* I.R.C. § 79 (2002).

127. *See* I.R.C. §§ 105 & 106.

128. *See* I.R.C. § 132 (2002).

129. Unlike consumers, who can shop at the stores of their choice, taxpayers must comply with one federal tax system administered by a monolithic bureaucracy.

130. Even "401(k)" plans subdivide into different underlying forms. *See* I.R.C. § 401(k)(1), which refers to "a profit-sharing or stock bonus plan, a pre-ERISA money purchase plan, or a rural cooperative plan" as possibly qualifying under the "401(k)" plan designation.

131. Like I.R.C.§ 401(k) plans, "simple retirement accounts" under I.R.C. § 408(p) permit participants to effect elective deferrals of compensation otherwise paid directly to them. *Cf.* I.R.C. §§ 408(p)(2) & 401(k)(2)(A) (West 2002).

132. I.R.C. § 403(b)(1)(E) authorizes annuities purchased under a salary reduction agreement, the same basic operative feature of plans under I.R.C. § 401(k) or 408(p).

133. I.R.C. § 457(a) authorizes elective deferrals similar to those of the plans mentioned in the previous note.

134. "SARSEP" stands for "salary reduction simplified employee pension." These plans must have been adopted prior to 1997. *See* I.R.C. § 408(k)(6)(H) (West 2002).

135. *See supra* notes 47-50 and accompanying text.

reliance on adversarial services, and imbue the system with greater certainty of results for both tax compliance and planning endeavors.[136] Such greater degree of uniformity will never materialize if Congress and tax regulators insist on maintaining and expanding a system that simultaneously accommodates too many particularized groups of taxpayers, each presumed to clamor for the maximum transactional flexibility possible.[137]

C. The Consistent Policy Virtue of Simplicity

Although simplicity can frequently result from elimination of too many taxpayer choices, sometimes tax complexity diminishes by granting taxpayers the right kind of choices. Thus, a few years ago the Treasury Department decided to curtail a great deal of administrative agony caused by complex attempts to determine when noncorporate entities should face taxation as though they were corporations.[138] By way of a wholesale regulatory reform, the Internal Revenue Service no longer had to battle with limited partnerships, limited liability companies, and similar noncorporate business entities and their owners to determine whether such entities possessed sufficient "corporate characteristics" to pay corporate income taxes instead of "passing through" various taxation features of the entity for direct recognition by the owners.[139]

Following this reform, the owners of such entities need only "check the box" on a standardized form if they do *not* want "pass through" treatment. Otherwise, taxation like a general partnership, which normally pays no entity tax, serves as the default standard without further inquiry by the Internal Revenue Service.[140] Taxpayers have a choice between corporate taxation or partnership taxation and do not have to straddle an abyss of complexity that puts the desired tax posture at odds with nontax structural elements implicit in

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136. *See supra* note 33 and accompanying text regarding regulatory use of a *uniform* table, which greatly simplified the minimum distribution regulations under I.R.C. § 401(a)(9).

137. Perhaps the worst way to treat taxpayers in groups is to create compliance forms specifically tailored for persons who wish to avoid complexity, then deny such taxpayers the full tax benefits associated with more complex forms. For instance, taxpayers wishing to set up a retirement plan based on employee elective deferrals can avoid the complexities of an I.R.C. § 401(k) plan by adopting the more user-friendly "SIMPLE" plan of I.R.C. § 408(p). Unfortunately, the path to simplicity in this case comes with a substantial tax benefit cost, since I.R.C. § 408(p)(2)(E) limits elective deferrals for the simpler plan to dollar amounts inferior to the elective deferral limits for I.R.C. § 401(k) plans. *See* IRS Notice 2001-84, 2001-53 I.R.B. 642 (2001).

138. *See* Treas. Reg. § 301.7701 (1967), which classified organizations for tax purposes according to a complicated analysis of certain deemed "[c]haracteristics of corporations."

139. I.R.C. § 11 provides corporations with their own rate table for the income tax they must pay. I.R.C. § 701 states: "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities."

140. *See* Treas. Reg. § 301.7701-3(c) (1995 and as subsequently amended).

their choice of entity.[141] The Treasury avoided an entire realm of complex and contentious audit activity by simply conceding to the fundamental tax planning desires of untold numbers of small business owners.[142]

Clearly, many ways exist for regulators to implement tax simplification. Taking away, or granting, choices to taxpayers can lead to simplification. Just as effectively, simplification can result when regulators forego "facts and circumstances" determinations,[143] do away with procedural and timing devices that can trap unwary taxpayers,[144] avoid regulations projects so complex that they necessitate a table of contents to orient the reader to too numerous sub-rules,[145] or refuse to issue rules that are more abstruse and difficult-to-read-than the Internal Revenue Code sections from which the interpretative rules come.[146]

By making simplicity a consistent internal policy virtue, regulators can commence their rulemaking exercises by first asking whether an interpretive issue lends itself to a terse, user-friendly standard. Before assuming a negative answer to this question, the rule writers should search their creative capacities, seek ideas from outside sources,[147] and bear in mind that they have been granted broad administrative powers by Congress to interpret the Internal Revenue Code in a variety of ways that do not have to reflect a purely adversarial attitude toward maximizing revenue production from the resolution of each and every tax issue.[148]

IV. CONCLUSION

Treasury regulations and other administrative promulgations currently present an almost schizophrenic two-faced expression. Some administrative rules operate simply enough to minimize the need for professional assistance when taxpayers face compliance or planning issues. Other rules operate in so

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141. Thus, limited liability entities other than actual corporations can avoid taxation as do partnerships under I.R.C. § 701 despite having dominant corporate characteristics.

142. Some business owners may desire corporate taxation for their noncorporate entities if they want to accumulate earnings indefinitely while enjoying potentially lower rates of income taxation under I.R.C. § 11 compared to higher rates such owners might experience personally under I.R.C. § 1 if partnership taxation were to apply.

143. *See supra* Part II.A.

144. *See supra* note 21 and accompanying text.

145. *See* Treas. Reg. § 1.401(a)(4)-0 (West 1993).

146. *Cf.* the text of I.R.C. § 401(a)(4) with that of its interpretive regulations in Treas. Reg. § 1.401(a)(4) (West 1993).

147. The Internal Revenue Service might, for example, solicit comments from taxpayers, practitioners, and tax policy organizations by framing issues *first* before actually drafting proposed regulations and then inviting the public to submit comments.

148. *See supra* Part II.B. of this article respecting the link between simplicity and generosity in tax rulemaking.

complicated a manner that even well versed experts decry the difficulty of working with them. Rulemakers can best serve the goals of efficiency, predictability, and clarity in the tax system by elevating rule simplification to the status of a primary policy virtue.

Making simplification itself a key policy consideration means that administrative interpretations of federal taxation laws cannot always proceed as exercises in advocacy favoring revenue enhancement.[149] Nor should rule makers over-emphasize potential demands to develop sets of rules for special classes of taxpayers—too much revenue pluralism does indeed complicate the system.[150] Examples of rule simplification, such as the recent regulations governing minimum retirement plan distributions, now abound. These streamlined rules suggest that tax administrators have both the creativity and authority to structure interpretive rules in ways that demystify formerly recondite portions of the Internal Revenue Code. Taxpayers and their advisers should demand that simplification efforts continue as a major policy prerogative leading to a more uniform regulatory countenance.

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149. If, in their attempt to connect simplicity with generosity in the formulation of tax rules, regulators too adversely affect revenue collections, Congress can always compensate accordingly by adjusting basic mechanisms in the Internal Revenue Code, like the rate tables in I.R.C. § 1 or the limitations on contributions and benefits for qualified retirement plans in I.R.C. § 415.

150. *See supra* notes 130-34 and accompanying text, discussing the unnecessary variety of retirement plan types involving employee elective deferrals.