

TAX SECTION

New York State Bar Association

Legislative Restrictions on Tax Regulations

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TAX SECTION

New York State Bar Association

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January 19, 1995

The Honorable Bob Dole
United States Senate
Washington, D.C. 20510

The Honorable Newt Gingrich
Speaker of the House
House of Representatives
Washington, D.C. 20515

Re: Legislative Restrictions on Tax
Regulations

Dear Senator Dole and Congressman Gingrich:

I am writing on behalf of the Tax Section of the New York State Bar Association to express our strongly held views that:

- any legislative moratorium on the issuance of regulations by the Executive branch should not apply to tax regulations issued by the IRS and Treasury Department, and
- additional burdens should not be placed on the issuance of tax regulations.

Our reasons for these conclusions are that:

- as indicated in a very recent GAO report, "businesses have difficulty with the [Internal Revenue Code] because of numerous and unwieldy cross-references and overly

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U.S. Activities of Foreign Taxpayers

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broad, imprecise and ambiguous language"¹

- as a result, all taxpayers (including individuals, small businesses and large businesses) are extremely dependent upon tax regulations to tell them the tax consequences of their activities, even ordinary and routine activities, and
- the uncertainties to taxpayers created by a freeze on tax regulations would be costly, disruptive and an inefficient use of resources.

I wrote a letter to you (and an identical letter to President Clinton) dated December 19, 1994 expressing these views in the context of your proposal for an immediate moratorium on all Federal regulations. A copy of that letter is attached. I am now writing to supplement our prior letter in light of the introduction of three bills in Congress that are applicable to tax regulations, and on which action may be taken shortly.

The remainder of this letter describes those bills and provides our comments with regard to the application of the bills to tax regulations. We express no views on the application of the bills to other regulations. We respectfully request the opportunity to present our views at the Congressional hearings to be held on these bills.

I. H.R. 450

H. R. 450 was introduced in the House of Representatives by Congressman DeLay on January 9, 1995, and referred to the Committee on Government Reform and Oversight.

Under the bill, (1) no federal regulatory rulemaking action (i.e., any rulemaking normally published in the Federal Register) could occur from the date of enactment

¹ Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, December 9, 1994).

through June 30, 1995, and ('2) in the' case of any rulemaking action taken between November 9, 1994 and the date of enactment, the effectiveness of that action would be suspended from the date 30 days after enactment until June 30, 1995. The only exception that might possibly apply to tax regulations requires the agency to certify that the regulation is limited to "repealing, narrowing, or streamlining a rule . . . or otherwise reducing regulatory burdens".

Any party adversely affected by an agency action in violation of these provisions can bring a civil action against the agency to obtain appropriate relief, as well as attorney fees.

Comments. We strongly urge that an exception to this bill be made for tax regulations. As stated above and in our prior letter, tax regulations in fact do reduce the burden on taxpayers by providing needed guidance as to the tax consequences of transactions. However, because the burden that is reduced is not "regulatory burden", H.R. 450 does not recognize this benefit to taxpayers and applies to these regulations.

Moreover, we wish to point out that our prior letter was directed solely at the adverse effects of a regulatory freeze on taxpayers. A regulatory freeze might well also have an adverse effect on government revenues. A taxpayer will commonly take a position for tax reporting purposes that is based on the most favorable interpretation of the Code and regulations that is reasonably possible. Such a position would normally not be subject to penalties.

However, if the Code is vague (as is often the case), extremely pro-taxpayer positions might be plausible in the absence of clarifying regulations, and a freeze on regulations would extend the period during which these positions could be taken. Even if a regulation has already been issued and is not subject to the freeze, the freeze would prevent the IRS from modifying the regulation if it

determines that taxpayers are interpreting the existing regulation in an unintended pro-taxpayer manner. In fact, Congress routinely adds a clause to new tax provisions authorizing regulations to prevent the avoidance of the provisions through various means, and now to prohibit the issuance of such regulations would certainly be contrary to the original Congressional intent.²

Beyond these considerations applicable to a freeze on new regulations, however, H.R. 450 raises further significant issues because of its "suspension" of the effectiveness of tax regulations already adopted since November 9. We believe such a suspension would cause still further disruption and unfairness far beyond that applicable to a freeze on new regulations.

The IRS regularly issues large numbers of "technical" regulations that affect all kinds of routine activities of taxpayers. Many of these regulations have been adopted since

² A freeze might even encourage taxpayers to take unusually favorable interpretations of the Code and existing regulations, with the knowledge that new regulations could not be issued in the near future and, when issued, would probably not be retroactive.

November 9 and are now in effect.³

Suspension of these existing regulations would have the following adverse effects:

1. Whether or not taxpayers like a particular regulation, taxpayers generally adjust their behavior and activities to conform to regulations as they are issued. If Congress were now to "suspend" regulations that were reasonably believed by taxpayers to be effective for the indefinite future, considerable unfairness could result to taxpayers who had arranged their affairs in reliance on these regulations. This would also foster disrespect for and distrust of the tax system, which could be quite harmful for the voluntary compliance that is necessary for the tax system to function.

³ For example, among the final or temporary regulations published in the Federal Register between November 9 and December 31, 1994, are those relating to (i) how individuals are to compute their alternative minimum tax liability (November 25), (ii) information reporting for the recipients of points on a residential mortgage (December 6), (iii) the exclusion from income for certain military moving allowances (December 21), (iv) withholding on distributions of Indian gaming profits (December 22), (v) defining "sewage facilities" eligible for tax-exempt bond financing (December 23), (vi) the requirements for natural gas producers to elect out of partnership rules (December 23), (vii) defining "compensation" for purposes of the Railroad Retirement Tax Act (December 23), (viii) authorizing modification of agreements for taxpayers to pay their tax in installments when the financial condition of the taxpayer deteriorates or improves (December 23), (ix) rules for the taxation of "built-in gain" of Subchapter S corporations that were previously C corporations (December 27), (x) the taxation of nuclear decommissioning funds on the disposition of an interest in the underlying power plant (December 27), (xi) rules on tax allocations following a contribution of appreciated assets to a partnership (December 28), and (xii) rules concerning the capitalization of interest for debt-financed real estate and other construction (December 29).

2. Enormous complexity and confusion would be created if an existing regulation were in effect for the beginning (and possibly the end) of 1995 and "no regulation" were in effect for a few months in the middle of the year. One of the biggest complaints taxpayers have about the tax system is its unpredictability and the constant changes to the rules. In its effort at regulatory reform, the bill would greatly exacerbate this problem.

3. Since many regulations (such as the alternative minimum tax regulation cited in the preceding footnote) determine the method of calculating taxable income for an entire calendar year, total confusion could result from two different methods being in effect for different portions of a year.

4. Taxpayers who are unfavorably affected by a particular regulation suspended by the bill would concentrate as many of their transactions as possible into the "gap" period. Conversely, taxpayers that are favorably affected by a suspended regulation would attempt to engage in their transactions before the suspension began or wait until the suspension ended. Of course, the same taxpayer might well be trying to engage in some types of transactions before or after the gap and in other types of transactions during the gap. All of this would create enormous economic inefficiencies as well as considerable revenue loss as the government is whipsawed by its on again/off-again regulations.

As a result of the foregoing, we reiterate our strong opposition to the application of H.R. 450 to tax regulations, and our particular concerns with the suspension of existing regulations.

II. S. 219

S. 219 was introduced in the Senate on January 12, 1995, by Senator Nickles and referred to the Committee on Governmental Affairs. We understand that hearings will

occur shortly. It is in general the same as H.R. 450, but contains an exception for actions "limited ... to issuing or promulgating a rule required to make effective tax relief provided by statute".

Comments. Our comments concerning H.R. 450 are equally applicable to S. 219. Moreover, as discussed below we do not believe that the exception for certain tax regulations will apply in more than a very small number of cases. As a result, we strongly urge that the exception be broadened to cover all tax regulations.

The reasons for our concern are as follows:

1. The exception only seems to apply if there is a provision of the Internal Revenue Code providing tax relief, and regulations are necessary to effectuate that relief. The fundamental problem is that the great majority of Code sections provide tax rules, not tax relief. Regulations interpreting these sections would therefore not be eligible for the exemption, even if they provide essential guidance and clarification to taxpayers.

2. Even regulations that were generally considered favorable to taxpayers would not be generally covered by the exemption. While such a regulation could itself be considered to provide "tax relief", it would generally not be effectuating a statutory provision providing tax relief. As a result, few if any tax regulations would be exempted from the freeze.

3. Because "tax relief" is not a term used in the Internal Revenue Code, it is completely unclear how the statutory exception would apply in numerous cases. This issue is more than academic because any affected taxpayer may bring suit under the civil enforcement provisions of the bill. Thus, considerable litigation over the meaning of "tax relief" could ensue.

Consider, for example, the common situation where a Code provision provides a basic taxing rule, an exception to taxation under that provision, and an exception to the exception. Is the IRS precluded from issuing a regulation under the basic rule, but permitted to issue a regulation under the exception? What about the exception to the exception?

As another example, consider Section 108(c), clearly a pro-taxpayer relief provision relating to the discharge of real property debt. Regulations under that section are eagerly awaited and would seem to be squarely within the scope of the exception. But would regulations be permitted under Section 108(c)(5), which specifically authorizes regulations "preventing the abuse of this subsection" through certain means?

4. Even statutory provisions that generally do provide tax relief may adversely affect some taxpayers. It is not clear whether a regulation under such a provision would be exempted from the freeze to the extent a particular taxpayer was adversely affected. If no adverse effect was permitted as to any taxpayer, the IRS is unlikely to be willing to issue regulations with such a one-sided effect, and the statutory exception would be meaningless.

For example, consider Section 197(e)(4)(D), which authorizes regulations to exempt taxpayers from 15-year amortization of intangibles if they acquire rights under a contract with a duration of less than 15 years. While regulations under this provision would almost always help taxpayers, some taxpayers with net operating losses might prefer the longer 15-year amortization. Would such a taxpayer be bound by a regulation' making the authorized "tax relief" effective for the great majority of taxpayers?

It might be thought that some of the above problems could be solved by revising the statute to allow regulations that themselves provide "tax relief" to taxpayers, even if the regulations are not based on a statutory tax

relief provision. However, this approach would leave intact the foregoing problems. Most tax regulations do not fit into the category of tax relief, since they have some provisions that taxpayers generally favor and others that taxpayers generally consider unfavorable. Moreover, even if a regulation is generally favorable (i.e., generally provides "tax relief") to taxpayers, unless a regulation provides a purely elective rule there are almost always some taxpayers who are adversely affected by the regulation. Unless the IRS was permitted to issue a balanced regulation that applied equally to all taxpayers, it would most likely not issue the regulation at all.

III. H.R. 9.

H.R. 9 was introduced in the House of Representatives on January 9 by Congressman Archer and others, and hearings are being held during January. Title VII of the bill, relating to regulatory reform, contains a number of provisions that would apply to tax as well as all other federal regulations.⁴

First, under section 7004 of the bill, a regulatory impact analysis would be required for any regulation affecting more than 100 persons. The analysis would be required to contain 23 items, including such items as a demonstration that the rule provides the least costly or least intrusive approach for meeting its intended purpose, a description of any (emphasis added) alternative approach considered by the agency or suggested by interested person

⁴ We also note Section 8101, in Title VIII of the bill, which provides that every person that is the subject of a federal "investigative or enforcement action" is entitled to a number of rights upon the "initiation of an inspection, investigation-, or other official proceeding". These rights include rights to remain silent, to be warned that statements can be used against them, to be advised whether the person has a right to a warrant, and to have an attorney or accountant present. It is not clear whether under the bill every IRS tax auditor will be required to provide such a statement of rights to every taxpayer at the commencement of an audit.

and the reason for the rejection, an estimate of the costs persons will incur in complying with the rule, an evaluation of the costs versus the benefits derived from the rule, an estimate of the cost to the agency for implementation and enforcement of the regulation, and so on.

In addition, under section 7006 of the bill, entitled "Standards of Clarity", no proposed regulation could be published in the Federal Register unless the director of the Office of Management and Budget certified that to the extent practicable, among other things, it (i) "is written in a reasonably simple and understandable manner", (ii) "is easily readable", (iii) "conforms to commonly accepted principles of grammar," and (iv) "does not contain any double negatives, confusing cross references, convoluted phrasing, unreasonably complex language, or term of art or word with multiple meanings that may be misinterpreted and is not defined".

Comments on Regulatory Impact Analysis.

We are very concerned that if the proposed regulatory impact analysis were applied to tax regulations, the resulting burden on the IRS would create a result that was similar to a freeze on tax regulations. Although intended to help the public, this requirement would have just the opposite effect, by making it harder for taxpayers to understand their tax obligations.

Assistant Secretary of the Treasury (Tax Policy) Leslie B. Samuels testified on January 10 that the regulatory impact analysis "would bog down the guidance process and increase compliance burdens on taxpayers". We agree. It is clear that compliance with the statutory standards would substantially increase the amount of paperwork involved in promulgating regulations, and require the shifting of personnel from the drafting of regulations to the procedural aspects of promulgating them.

Moreover, we note that the IRS generally publishes extensive preambles to proposed and final tax regulations explaining the reasons for the principal decisions made in the regulations. We are not aware of any significant taxpayer demand that these explanations be expanded. In fact, in our experience the IRS officials whose names and telephone numbers are given in these preambles are generally quite willing to discuss the regulations. In addition, under Section 7805(f) of the Internal Revenue Code, the IRS is already required to specifically consider the impact of regulations on small business.

Finally, it is not at all clear how some of the items in the regulatory impact analysis are intended to apply to tax regulations. For example, given that the purpose of the tax statute is to raise money, how does one demonstrate that a particular regulation "provides the least costly or least intrusive approach for meeting its intended purpose"?

As a result of the foregoing, we believe the regulatory impact analysis should not apply to tax regulations, or at least should be modified to greatly reduce the burden and better reflect the purposes of tax regulations.

Comments on Standards of Clarity. We applaud the goal of clear and simple regulations of all types, including tax regulations, and we routinely make suggestions for simplifying regulations.⁵ Moreover, we applaud the progress the IRS has made in recent years in issuing clearer and simpler regulations.

The problem, however, is that, as indicated in our prior letter, the Internal Revenue Code itself is extraordinarily complex and does not come close to meeting any one of the standards of clarity quoted above. Moreover, when Congress cannot determine the appropriate

⁵ We note that the goal of simple regulations is not universally accepted. Some taxpayers prefer more detailed regulations to cover every situation that they might encounter, and dislike the broad anti-abuse rules that the IRS generally feels are necessary to accompany less detailed regulations.

manner in which a particular Code provision should apply to a complex situation, it generally delegates to the IRS the power to issue regulations to deal with the difficult situation.

As a result, we think it is simply quixotic to expect that the Code can be interpreted with "easily readable" regulations. We believe that the goal of simple tax regulations cannot ultimately be successful except at the margins until Congress greatly simplifies the Code. Moreover, some transactions engaged in by taxpayers are extremely complex and, aside from whether the relevant Code provisions are simple or complex, require complex regulatory responses.

We believe that either the Standards of Clarity in the bill will in effect be ignored for tax regulations (perhaps under the guise that the Standards only apply "to the extent practicable"), or else the Standards will be followed and regulations will be severely delayed or not issued at all. Neither of these outcomes is desirable. We therefore believe that either the Standards should not apply to tax regulations in the first instance, or at least there should be an acknowledgment in the statute or legislative history that tax regulations cannot "practicably" be expected to be much simpler than the statute they are interpreting, or to be much less complex than the transactions on which they are providing guidance.

4. Conclusion

Consistent with our prior letter, we strongly oppose these bills to the extent that they would have the effect of freezing tax regulations or making their issuance more difficult. We believe that reform in the tax area should start with the Internal Revenue Code, not with the regulations interpreting the

Code for taxpayers.⁶ Even to the extent present regulations can be simplified, a freeze is not the right way to go about the simplification effort.

In fact, given the present state of the Code, legislation requiring "easily readable" tax regulations is an example of Congress requiring others to apply a standard from which Congress itself is exempt. No expert or nonexpert in the tax law would call the Code itself "easily readable", and there is no shortage of "confusing cross references" and "convoluted phrasing". Moreover, Congress routinely delegates to the IRS the "dirty work" of writing regulations to deal with situations too complex for Congress itself to resolve in the statute. It would therefore be extraordinary for Congress now to demand that tax regulations be simple.

We have and will continue to support simplification of the Internal Revenue Code, and renew our offer to be helpful to the tax staffs in that effort in any way possible. However, until such simplification of the statute occurs, taxpayers will be largely dependent on tax regulations for guidance. We believe it simply makes things worse to begin the reform effort by reducing the guidance available to taxpayers.

Very truly yours,

Michael L. Schler
Chair, Tax Section

⁶ We note the recently expressed view that a moratorium on tax regulations would be a good idea because it would force attention to be placed on the complexity of the Code, and presumably put additional pressure on Congress to simplify the Code. Henderson, "The NYSBA Tax Section's Call for More Regulations," Tax Notes, January 16, 1995, page 436. Mr. Henderson agrees, however, that a moratorium would make no sense unless Congress were in fact to use the interim period to simplify the Code.

cc: Senator John Glenn
Senator Daniel P. Moynihan
Senator Don Nickles
Senator Bob Packwood
Senator William Roth, Jr.

Congressman Bill Archer
Congressman William F. Clinger, Jr.
Congressman Cardiss Collins
Congressman Tom DeLay
Congressman Sam Gibbons

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December 19, 1994

Senator Bob Dole
United States Senate
Washington, D.C. 20510

Representative Newt
Gingrich House of Representatives
Washington, D.C. 20515

Application of Proposed Regulatory Freeze to Tax Regulations

Dear Senator Dole and Representative Gingrich:

I am writing on behalf of the Tax Section of the New York State Bar Association in connection with the immediate moratorium on federal regulations recently proposed in a letter sent by you and others to President Clinton. I understand President Clinton has rejected the proposal, but I am writing to express our views in case the same issue arises in the future.

We urge in the strongest possible terms that any moratorium on regulations not apply to tax regulations issued by the Internal Revenue Service and the Treasury Department. This position was adopted by a unanimous vote of our Tax Section Executive Committee at a meeting attended by 37 tax lawyers of all political persuasions. We took the same position in 1992 when President Bush was considering a moratorium on regulations. (A copy of our prior letter is attached.) Moreover, we note that your letter contemplates the possibility of exceptions to the moratorium, although it does not mention tax regulations specifically.

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There are several reasons for our position. The Internal Revenue Code, which is the statute interpreted by tax regulations, is not a simple statute. It is well described in a GAO Report requested by Representative Houghton (Ranking Minority Member of the Oversight Subcommittee of the House Ways and Means Committee) and released this past week:

"Business officials and tax experts told us that, overall, the federal tax code is complex, difficult to understand, and in some cases indecipherable More specifically, they said businesses have difficulty with the code because of numerous and unwieldy cross-references and overly broad, imprecise, and ambiguous language."^{1/}

As a result of this complexity, taxpayers are extremely dependent upon tax regulations to tell them the tax consequences of their activities and transactions. An absence of regulations often results in great uncertainty about the tax consequences of proposed actions, even if the actions are ordinary and routine. The risk of unexpected tax liability resulting from tax uncertainties creates economic disincentives for normal commercial activity (and even burdens routine personal tax planning). The consequence is considerable economic inefficiency and dislocation. This effect applies to the entire spectrum of taxpayers, including large corporations, small businesses, real estate owners and individuals. An absence of regulations also results in increased tax litigation, because of differing interpretations of the Internal Revenue Code by IRS agents and taxpayers.

Taxpayers and taxpayer groups therefore spend an enormous amount of time and energy requesting (sometimes even begging) the IRS and Treasury to issue regulations in a variety of areas. The overwhelming complaint among taxpayers and tax lawyers is that the IRS and

^{1/} Tax System Burden: Tax Compliance Burden Faced by Business Taxpayers (GAO/T-GGD-95-42, December 9, 1994). The Appendix to the study states that the companies studied were mostly medium-sized, and that the results concerning the sources of tax compliance burden were consistent with the literature that was reviewed.

Treasury take too long to issue regulations, and that there are too few rather than too many regulations.

This again is confirmed by the GAO report quoted above. The report discusses at length problems that businesses have with the complexity of the Internal Revenue Code itself, but its only discussion of tax regulations is that the lack of regulations makes things worse:

"Of those [business officials and tax experts] who cited difficulties with IRS, problems identified were the amount of time IRS takes to issue regulations For many tax provisions businesses depend upon IRS regulations for guidance in complying with the code and correspondingly reducing their burden. Without timely regulations, according to some respondents, businesses must guess at the proper application of the law and then at times amend their decisions when the regulations are finally issued."

As a result, a freeze on tax regulations would be extremely costly and disruptive. An immediate freeze would already have precluded the issuance on December 15 of long-awaited (and taxpayer-favorable) proposed regulations concerning the tax treatment of an employer's reimbursement of travel expenses of the spouse of an employee. Solely for illustrative purposes, taxpayers are currently awaiting regulatory guidance from the IRS on such matters as environmental settlement funds, real estate mortgage workouts, purchases of computer software and other intangibles, and the substantiation requirements for charitable contribution deductions.

The situation involving tax regulations should be contrasted with the reasons for a regulatory moratorium stated in your letter: that overregulation imposes costly burdens and slows economic growth and job creation. We have no particular expertise outside the tax area and pass no judgment on the merits of a moratorium generally. However, we do believe as tax lawyers that the stated reasons have little or no application to tax regulations, and that the economic benefits of issuing tax regulations far outweigh any disadvantages. As a result, we strongly oppose a moratorium on tax regulations.

We are sending a substantially
identical letter to President Clinton.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Senator Thad Cochran
Senator Trent Lott
Senator Daniel Patrick Moynihan
Senator Don Nickles
Senator Bob Packwood

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January 22, 1992

President George Bush
 The White House
 Washington, D.C.

Dear President Bush:

On behalf of the Tax Section of the New York State Bar Association, I strongly urge that any moratorium on regulations you announce not apply to regulations issued by the Internal Revenue Service.

Representatives of the Internal Revenue Service have announced that a significant number of regulations on which they are working are likely to be issued in proposed or final form during the next three months. A number of these regulations interpret provisions of the Internal Revenue Code that were enacted more than five years ago. United States taxpayers, including corporations, need the interpretative assistance these regulations will provide.

Press reports indicate that the goal of a regulatory moratorium is to stimulate the economy by removing costly and burdensome regulations that affect U.S. businesses. Issuance of these tax regulations, however, would for the most part benefit U.S. businesses, by resolving uncertainties that inhibit productive activity.

The 1981 moratorium ordered by President Reagan specifically excluded regulations issued by

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the Internal Revenue Service. Any moratorium
you order should do likewise.

Respectfully submitted,

James M. Peaslee
Chair

cc: Hon. Kenneth W. Gideon
Hon. Fred T. Goldberg, Jr.
Abraham N.M. Shashy, Jr., Esq.