ATTRACTIVE COMPLEXITY: TAX DEREGULATION, THE CHECK-THE-BOX ELECTION, AND THE FUTURE OF TAX SIMPLIFICATION

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I. INTRODUCTION

Dissatisfaction with the complexity of the income tax is nothing new.[1] Still, recent decades have seen anything but a decrease in the tax law's complexity. The seemingly inexorable rise in complexity has attracted the attention of scholars,[2] inspired politicians[3] and, of course, frustrated taxpayers. Typically it is assumed that what puts simplicity, or at least simplification,[4] out of reach is a lack of political viability.[5] In other words, the lack of a political constituency for tax simplification[6] makes it inevitable that other tax policy concerns will take precedence over simplicity. As a result, simplification becomes the tax law's equivalent of a perennially ill-fated New Year's resolution.

It appears that tax simplification may have finally found the political support it has long lacked.[7] Recent high-level political interest

1. "If [present legislation] is not simplified, half of the population may have to become tax lawyers and tax accountants." HENRY C. SIMONS, FEDERAL TAX REFORM 28 (1950).

2. *See, e.g.*, Boris I. Bittker, *Tax Reform and Tax Simplification*, 29 U. MIAMI L. REV. 1 (1974); Martin D. Ginsburg, *Tax Simplification—A Practitioner's View*, 26 NAT'L TAX J. 317 (1973); Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WIS. L. REV. 1267; Deborah H. Schenk, *Simplification for Individual Taxpayers: Problems and Proposals*, 45 TAX L. REV. 121 (1989); Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 LAW & CONTEMP. PROBS. 673 (1969).

3. President Bush has strongly supported simplifying the income tax. *See* Edmund L. Andrews, *Fed's Chief Gives Consumption Tax Cautious Backing*, N.Y. TIMES, Mar. 4, 2005, at A1 (quoting President Bush as saying that, "I've told the American people I want to work to simplify the tax code to make it easier to understand so that people are spending less time filing paper"). President Clinton also proposed ways to make the tax law simpler. *See* Robert D. Hershey, Jr., *Clinton Presents a Proposal to Simplify the Tax Code, with Changes Large and Small*, N.Y. TIMES, Apr. 15, 1997, at A23.

4. An incremental improvement in simplicity.

5. *See* McCaffery, *supra* note 2, at 1268.

6. *See id.*

7. President Bush recently signaled his commitment to tax simplification by forming a

in tax simplification caps decades of growing enthusiasm for a simpler tax system. Although awareness of the complexity problem has continued to broaden, the tax law continues to confound attempts to achieve greater simplicity. Even simplification reforms widely viewed as successful do not always advance Henry Simons's half-century-old goal of limiting the resources society devotes to the tax law.[8] This Article examines the most important simplification reform of the last decade to reveal a crucial flaw in the conventional wisdom that the only serious obstacle to simplification is political in nature.

If it were true that the tax law's ever-increasing complexity was merely a product of political failure, the check-the-box election, by all accounts a political success story, should have unambiguously diverted public and private resources away from the tax law. Similarly, if political inattention were solely to blame for the failure to rein in complexity, the higher political profile that tax simplification has enjoyed in recent years should have gone some distance towards decreasing the tax law's complexity. Concluding that the check-the-box election failed to produce a clear improvement in simplicity and that the tax law's complexity has not been significantly affected by the public's growing interest in simplification would suggest an alternative explanation of complexity's relentless advance.

This Article demonstrates that commentators deserve to shoulder some of the blame for complexity's resilience. Tax experts have failed to draw a distinction between two related concepts: tax deregulation and tax simplification. The product of that failure, tax rules that are appealing to taxpayers even though they are not simple, can be seen clearly in the check-the-box regulations. Those regulations, first outlined in 1995 and finalized less than two years later, aimed to simplify the income tax by revising the rules governing the classification of business entities, a doctrinal area that had become an expensive quagmire for taxpayers.[9] The primary innovation they employed to combat complexity was electivity.[10]

In late 1996, the Treasury Department issued final regulations

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"bipartisan panel to advise on options to reform the tax code to make it simpler, fairer, and more pro-growth to benefit all Americans." *See* President's Advisory Panel on Federal Tax Reform, http://www.taxreformpanel.gov/ (last visited Feb. 16, 2006).

8. *See supra* note 1.

9. "Taxpayers and the [Internal Revenue] Service . . . continue to expend considerable resources in determining the proper classification of domestic unincorporated business organizations." I.R.S. Notice 95-14, 1995-1 C.B. 297, 297 [hereinafter Notice 95-14].

10. "The Internal Revenue Service and the Treasury Department are considering simplifying the classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis." *Id*.

creating the check-the-box election.[11] The election, a significant departure from the mandatory rules that had previously governed the classification of business entities, permitted many entities to choose and even change their federal tax classification. This reform replaced prior regulations dating from 1960 that had evaluated four objective factors to detect a critical mass of "corporate characteristics" in order to distinguish business entities classified as partnerships for tax purposes from those classified as corporations.[12]

The story of the check-the-box election suggests that even when political barriers to simplification are overcome, reforms intended to make the tax law simpler can miss the mark. Eliminating the four-factor test clearly simplified the law. On the other hand, the election, both as the primarily domestic proposition initially described by Notice 95-14[13] and as ultimately applied to domestic and foreign entities, arguably made the tax law more complex. Because of the enthusiasm taxpayers have shown for the check-the-box election, this is a surprising result. Given that the election was designed specifically and exclusively to simplify, it is also a troubling one.

The explanation for this apparent blunder (a simplification measure that fails to simplify) lies in the difference between tax deregulation and tax simplification. In particular, the key to understanding why the election succeeded as a deregulatory reform even though it failed to produce a clear increase in simplicity is that not all complexity reduces taxpayers' well-being. Deregulation is driven by the desire to limit the burdens government imposes on taxpayers,[14] rather than to preserve scarce societal resources. As a result, deregulation is entirely compatible with certain kinds of complexity. Put another way, tax deregulation treats as benign any complexity that taxpayers find attractive rather than burdensome.

In some cases, a tax rule that is complex is treated as benign because its existence economically benefits rather than burdens

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11. *See* T.D. 8697, 1997-1 C.B. 215.

12. *See* Treas. Reg. §§ 301.7701-1 to -3 (1960).

13. The Notice suggested that, in addition to making the classification of domestic entities elective, the possibility of making the election available to foreign entities was also being considered. *See* Notice 95-14, *supra* note 9, at 298-99. However, the creation of the domestic election was not contingent on the existence of a non-U.S. election. *See id*.

14. Deciding whether or not reducing taxpayer burdens is a normatively desirable goal is beyond the scope of this Article. Tax cuts are widely thought to promote economic growth by reducing burdens on taxpayers. However, in some situations, tax cuts might retard economic growth by producing budget deficits that lead to higher interest rates. This Article does advocate tax deregulation, either in the form of tax cuts or changes such as the creation of the check-the-box election.

taxpayers subject to it. Even though such a rule causes taxpayers and tax authorities to devote valuable time and resources to understanding and successfully managing the tax law's requirements, it is tolerated by affected taxpayers because it offers them an economic benefit that more than compensates them for their efforts and expenditures.

The conflation of tax deregulation and tax simplification and the differentiation between burdensome complexity and attractive complexity have become important obstacles to the goal of producing simpler tax laws. Tax deregulation, like deregulation generally, arguably serves important societal objectives.[15] Deregulation's emphasis on taxpayer benefits and burdens reflects an important shift in the popular conception of the relationship between taxpayers and the government towards what has been called the "consumer paradigm."[16] Viewing taxpayers as consumers of government services and gauging the success of government action by the "personal benefits"[17] created by the action makes taxpayer preference central to the design and administration of the tax law.

As the creation of the check-the-box election illustrates, although attention to taxpayer preference can produce positive outcomes, it can also obscure important information. Quite reasonably, most taxpayers hesitate to attach the negative label "complex" to tax rules that, like the check-the-box election, they perceive to be beneficial. As a result, when taxpayer preference is relied on to identify complexity, attractive complexity is effectively masked and tax deregulation becomes indistinguishable from tax simplification.

The failure to treat attractive complexity like burdensome complexity is problematic for two reasons. The first is that the normative objections to complexity, the most important being that tax complexity results in the misallocation of society's resources,[18] are not contingent on

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15. Eliminating economic burdens on taxpayers may encourage productive economic activity. For example, reducing marginal tax rates may encourage taxpayers to work more by permitting them to keep more of their earnings. On the other hand, it may discourage economically productive activity by permitting taxpayers to shift more of their time towards leisure activities without reducing their after-tax income.

16. LIZBETH COHEN, A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA 396 (2004). Cohen uses that phrase to refer to the tendency, beginning in the late 1970s, of Americans to view their relationship with government in terms of "satisfying the private interest of the paying customer, the combined consumer/citizen/taxpayer/voter whose greatest concern is, 'am I getting my money's worth?'" *Id*. at 397.

17. *Id*.

18. Resource misallocation and waste are the problems most commonly identified with tax complexity. *See, e.g.*, SIMONS, *supra* note 1, at 28; Nell Henderson, *Time to Change Tax Code Again, Greenspan Says: 1986 Law Presented as Model of Reform*, WASH. POST, Mar. 4, 2005, at E2 ("'A simpler tax code would reduce the considerable resources devoted to complying with the

the preferences of taxpayers directly subject to its burdens. Tax complexity's "victims" may actually be economically better off under a complex rule than they would be under a relatively simple rule, even though complying with the more complex rule consumes significant societal resources. This would be true, for example, whenever the taxpayers' heightened costs under the complex rule are more than offset by the value of the tax benefits produced by it. Complex tax provisions like the Earned Income Tax Credit[19] ("EITC") offer a clear illustration of this phenomenon. The rules governing the credit are complex,[20] yet the economic benefit provided to eligible taxpayers more than outweighs the costs it imposes. For affected taxpayers this is beneficial complexity, but there is no reason to believe that such attractive complexity consumes fewer resources than burdensome complexity.

The other problem is that some of the harmful effects of complexity are likely to be hidden from, and therefore not accounted for in the preferences of, taxpayers. An example of such an effect is the observation that complexity tends to breed further complexity.[21] Simplification reforms targeting only burdensome complexity would leave a great deal of complexity untouched. The surviving complexity, even if it is attractive, would give rise to more complexity. That second generation of complexity may be attractive, burdensome, or a combination of both. Both of these limitations on the ability of deregulatory reforms to produce simpler tax laws can be discerned in post-check-the-box developments in the entity classification regime.[22]

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current tax laws, and the freed-up resources could be used for more productive purposes,' Greenspan said."). Both Greenspan and Simons urge greater simplification, not because taxpayers dislike complexity, but because complexity consumes society's resources. *See id.* Given a finite population, an abundance of tax lawyers is undesirable because it will decrease the number of engineers and poets. Likewise, public and private resources devoted to complying with and enforcing the tax law cannot be spent curing disease or fighting terrorism.

19. I.R.C. § 32 (2000).

20. *See* Schenk, *supra* note 2, at 140-42.

21. *See* DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 5 (1986) ("A kind of vicious circle has been at work, with complexity breeding more complexity."); McCaffery, *supra* note 2, at 1278 ("Small amounts of complexity beget significantly greater amounts . . . .").

22. An example of the first problem, the waste of societal resources, would be the resources devoted to devising tax-planning strategies that employ check-the-box elections. *See* Joni L. Walser & Robert E. Culbertson, *Encore Une Fois: Check-the-Box on the International Stage*, 76 TAX NOTES 403, 403 (1997) ("If popularity is a true measure of quality, the check-the-box rules must be the best regulations ever written. They have been trumpeted as the greatest tax-planning development since the invention of numbers . . . ."). The best example of Bradford's "vicious circle," *supra* note 21, is the proposed response to one of those strategies, namely, the "extraordinary transaction" regulations. *See* Prop. Treas. Reg. § 301.7701-3(h)(1), 64 Fed. Reg. 66,591, 66,594 (Nov. 29, 1999). Those rules were ultimately withdrawn after they were strongly criticized on the basis that the amendments would "unnecessarily erode the simplicity and certainty achieved by the check-the-box regulations generally." A.B.A. SECTION TAX'N, COMMENTS

If the current push to simplify the tax law is to succeed in advancing simplification's normative objectives, where the creation of the check-the-box election did not, lawmakers must abandon the fallacy that taxpayers can be relied on to make useful distinctions between types of complexity. This Article uses the creation of the 1996 check-the-box entity classification regulations as a case study of how a focus on taxpayer preferences can undermine efforts to manage the tax law's complexity. It then examines two 2005 simplification proposals to determine whether taxpayer preferences continue to cause reformers to confuse tax deregulation and tax simplification.

Part II begins with a discussion of simplification, attractive complexity and deregulation. Part III examines how entity classification became complex and how the check-the-box regulations attempted to make it simpler. Part IV then explores how the rational but problematic distinction between attractive and burdensome complexity produced the signature feature of those regulations, the check-the-box election, a tax rule that is itself a significant source of complexity. Part V analyzes two simplification proposals recommended by the President's Advisory Panel on Tax Reform and finds that they repeat the errors that produced the check-the-box election.

II. SIMPLIFICATION

Simplification has been described as the "holy grail" of tax policy.[23] The characterization fits both because of the passion simplification generates and because it has proven to be such an elusive goal.[24] One reason simplification has been so difficult to achieve is that "[n]either 'tax simplification' nor its mirror image, complexity, is a concept that can be easily defined or measured."[25] The only way to quantify rule, transactional, or compliance complexity[26] is to do so indirectly. For

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CONCERNING PROPOSED TREASURY REGULATION 301.7701-3(h), Part II.2, *reprinted in Members of ABA Tax Section Criticize Proposed Check-the-Box Regs.*, TAX NOTES TODAY, Aug. 15, 2000, at 158-46.

23. McCaffery, *supra* note 2. Some scholars have been more skeptical of the importance of simplification. *See, e.g.*, Samuel A. Donaldson, *The Easy Case Against Tax Simplification*, 22 VA. TAX REV. 645, 743 (2003) ("It is a mistake to distinguish simplicity as a tax policy criterion distinct from efficiency. Simplicity is part of what scholars mean by efficiency, nothing more.").

24. *See* Steve R. Johnson, *Administrability-Based Tax Simplification*, 4 NEV. L.J. 573, 573 (2004).

25. Bittker, *supra* note 2, at 1.

26. These are the three types of complexity. Rule complexity refers to the challenge of interpreting tax rules, transactional complexity to the hardships related to altering behavior to benefit from those rules, and compliance complexity to the problems taxpayers encounter in ensuring their ongoing compliance with the rules. *See* BRADFORD, *supra* note 21, at 266-67. If the tax law could be compared to a game of Twister, the burden of understanding what hand or foot

example, a change in complexity can be measured by evaluating the impact of a rule change on the amount of resources taxpayers and the government dedicate to fulfilling their respective obligations under the old rule and the modified rule. This is not measuring complexity directly, but it can be used as a proxy for complexity.[27]

It may still be correct, as it was more than a half century ago, to say that "[s]implicity in modern taxation is a problem of basic architectural design"[28] and that the tax law "is insufferably complicated and nearly unintelligible,"[29] but neither observation offers would-be simplifiers a road map to a simpler income tax. It is easier to observe that the tax law is complex, and therefore consumes more resources than we would like, than it is to produce tax rules that consume fewer resources. Using fewer words might seem an obvious way to make a tax provision less complex, but it may actually have the opposite effect. This is because facially complicated statutory language may actually "clarify the law" by making it "easier to find one's way through the wilderness."[30] In such cases, simplicity and complexity can become intertwined in a way that defies easy line drawing.[31] Even if a consensus existed that simplification should be the primary objective of tax policy, the absence of a consensus as to how to achieve that goal would confound attempts to make the tax law truly simple.

A. What is Attractive Complexity?

Finding solutions to the problem of complexity in the tax law is made more difficult by the deep ambivalence taxpayers display towards complexity.[32] President Bush, for example, has committed to tax

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belongs on a particular circle would be rule complexity, the difficulty of actually putting the hand or foot on that circle and maintaining whatever contortions are necessary to keep it there would be transactional complexity, and the vigilance necessary to prevent an inadvertent rule violation would be compliance complexity.

27. "In my view the most informative measure of tax complexity is the resource cost of collecting taxes. This is equal to the IRS budget plus the value of the time and money spent by the taxpayers and third parties to the collection process (such as employers who withhold tax for their employees.)." *Tax Reform: Hearings Before the H. Comm. on Ways & Means*, 109th Cong. (2005) (statement of Joel B. Slemrod, Paul W. McCracken Collegiate Professor of Bus. Econ. and Pub. Policy, Professor of Econ., and Dir. of the Office of Tax Policy Research, Univ. Mich.).

28. SIMONS, *supra* note 1, at 28.

29. *Id.*

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

31. *See, e.g.*, McCaffery, *supra* note 2, at 1270 ("While the intricacy of particular Code sections may make reading or understanding them difficult, some abstruse language yields fairly determinate results, and other, facially complex language forecloses manipulation by tax planners, simplifying taxpayer behavior. Conversely, some very simple terms yield a dizzying array of interpretations.").

32. "The same polltakers who in 1985 record so much dissatisfaction with the income tax, so

simplification as one of the key goals of his second term in office.[33] At the same time, presumably to alleviate taxpayer concern that tax simplification would result in the elimination of popular, but complex, tax benefits, President Bush has affirmed his support for provisions that add considerable complexity to the tax law such as the deduction for charitable contributions and the many ways in which the income tax provides incentives to homeownership.[34] This inconsistency reflects a rational taxpayer preference for bearing complexity that produces benefits that more than offset their "cost" in resources for that taxpayer.[35] Of course, even though individual taxpayers may find such complexity attractive, it is not clear that tolerating it is prudent as a tax policy matter.

One reason for the disparity between individual preferences and the socially optimal level of tax complexity is that not all of the costs of complexity are borne directly by or distributed equally among taxpayers.[36] Eliminating burdensome record-keeping requirements, for example in the context of deductions for business-related meals,[37] would result in a reduction in compliance complexity for affected taxpayers. This reduction in complexity would make the process of claiming a deduction for the cost of a business meal less costly for a typical taxpayer. However, that apparent simplification will not necessarily result in fewer societal resources being devoted to determining the tax consequences of business meals.

While reducing up-front taxpayer compliance costs, the modified rule could nevertheless consume an increased amount of societal

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much desire for simplification and lower rates, also record the fierce reaction of people to any threat to 'their' preferences, whether it is deductible mortgage interest or tax-free medical insurance." BRADFORD, *supra* note 21, at 6.

33. *See* President's Advisory Panel on Federal Tax, http://www.taxreformpanel.gov/ (last visited Feb. 16, 2006) (identifying the ambition to "simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws" as the first priority of the bipartisan tax reform panel).

34. *See id.*

35. *See, e.g.*, Deborah H. Schenk, *Positive Account of the Realization Rule*, 57 TAX L. REV. 355, 376 (2004). ("Taxpayers are quite willing to accept a large number of complex rules that encourage transactional complexity (so long as they perceive that they will benefit from their use).").

36. The lion's share of the costs will fall directly on taxpayers and the government. Given that government costs are ultimately borne by taxpayers, all of those costs are directly or indirectly taxpayer costs. Taxpayers and the government are probably the most conspicuous constituencies with an interest in the tax law's complexity. However, they are not alone. A more comprehensive list might include "the tax preparer, the tax planner or advisor, the Internal Revenue Service (IRS), the courts, the tax legislative system, academics or economists" as constituencies with a stake in the complexity of the tax law. McCaffery, *supra* note 2, at 1272. One could also include state, local and even foreign tax authorities.

37. I.R.C. § 274(d) (2000).

resources. That is because in addition to eliminating compliance complexity it would also create rule complexity, primarily in the form of uncertainty. Controversies regarding what sorts of records would support a deduction would inevitably arise, triggering significant public and private expenditures.[38] Most taxpayers claiming those deductions would only bear a small portion of the costs of that complexity, with the bulk falling on taxpayers actually involved in litigation. As a result, a typical taxpayer may well exhibit a rational *ex ante* preference for the new rule over the old. Nevertheless, inferring from that taxpayer preference that this change would simplify the tax law would be inappropriate.

Two examples of complex tax rules illustrate the degree to which individual taxpayer preferences fail to provide reliable information regarding the complexity of a tax rule. Few would be surprised that individual taxpayers prefer levels of complexity lower than the socially optimal level or that they might be indifferent to excessive complexity borne by other taxpayers. The less intuitive possibility is that the very taxpayers affected by complexity, the apparent victims, may sometimes rationally prefer too much of it.

The passive loss rules[39] landed what may have been the decisive blow against the individual tax shelters that had become commonplace during the 1970s and early 1980s. They did so by creating a set of rules that isolated investment losses from active business income. The statutory and regulatory provisions implementing the concept are a study in rule and compliance complexity. They are difficult to understand and impose enormous record-keeping responsibilities on taxpayers involved in "passive" activities.

One might assume that all taxpayers that dislike the passive loss rules do so at least in part because the rules subject them to increased complexity. After all, it is easy to understand why taxpayers dislike complexity. However, that aversion is often only part of the story. By imposing costs and burdens on taxpayers engaged in passive activities, the provision's rule and compliance complexity obviously leaves those taxpayers less well off than they would otherwise be. On the other hand, by discouraging other taxpayers from engaging in tax shelter transactions, the substantive loss disallowance rules actually decrease the amount of transactional complexity that the second group of taxpayers would rationally choose to bear.

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38. Before the creation of I.R.C. § 274(d) and its taxpayer substantiation requirement, the enforcement of a similar standard consumed considerable taxpayer and IRS resources. *See* Norman H. Lipoff, *Entertainment and Related Expenses Under Legislative Attack*, 17 TAX L. REV. 183, 191-93 (1962).

39. I.R.C. § 469 (2000).

If the resulting reduction in transactional complexity outweighed the increased rule and compliance complexity, the apparently complex rules would actually reduce the tax law's complexity.[40] For the first group of taxpayers, complexity offers no countervailing benefits. For them, the complexity is burdensome. For the second group, the additional transactional complexity they would encounter upon a repeal of the passive loss rules might be more than offset by the tax benefits produced by investing in tax shelters. Although the transactional complexity associated with the tax shelter investment might cost a "typical" taxpayer[41] $100, tax benefits of $101 would make the complex tax shelter investment attractive. As a result, a rational taxpayer in that group would choose to bear that increased transactional complexity, effectively preferring complexity over simplicity.

The phenomenon of taxpayers rationally preferring complexity is nicely illustrated by the EITC.[42] Unlike the passive loss rules, the net complexity impact of which is debatable, the existence of the EITC clearly increases the complexity of the tax law. It requires low-income taxpayers to understand and comply with rules so complicated that the IRS publication explaining the relevant rules and calculations is more than fifty pages long,[43] considerably longer than the instructions for the entire Form 1040EZ. For all the rule and compliance complexity the EITC imposes, it provides eligible taxpayers with crucial benefits by acting as a wage subsidy for low-income workers.[44] As a result, an economically self-interested taxpayer would choose the combined costs and benefits of the EITC over a world without either. For this reason, from an individual taxpayer perspective, the complexity of the EITC is beneficial, and therefore attractive, complexity.

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40. *See* Stanley A. Koppelman, *At-Risk and Passive Activity Limitations: Can Complexity Be Reduced?*, 45 TAX L. REV. 97, 105-06 (1989) (finding a net reduction in complexity under I.R.C. § 469).

41. Throughout the Article, assumptions are made about the homogeneity of taxpayers that ignore factors specific to particular taxpayers that may make them atypical. For example, not every low-income taxpayer will benefit from the EITC's complexity. Many will perform complex calculations, or pay someone else to do so, only to find that they do not qualify for the EITC or that they qualify for a credit that does not entirely offset their costs. For those taxpayers, the EITC is burdensome complexity, not beneficial complexity.

42. *See* I.R.C. § 32 (2000).

43. *Earned Income Credit*, 2 I.R.S. Pubs. 596 (CCH) ¶ 44,721 (1993).

44. *See* Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405 (1997).

B. Attractive Complexity is Not Benign

If we, like Henry Simons,[45] Joel Slemrod,[46] and Alan Greenspan,[47] value simplicity because it preserves scarce societal resources, then it is important to recognize that attractive complexity is not benign. Taxpayers' ambivalence towards complexity should not affect how we measure it. To put it another way, complexity consuming $100 worth of society's resources is just that, however appealing taxpayers find it.

A rational taxpayer's acceptance of attractive complexity does not indicate that it is not harmful, but rather that the cost of the complexity borne by the taxpayer is exceeded by the benefit she enjoys as a result of the existence of the complex provision. Such attractive complexity may be found not to conflict fatally with lawmakers' policy objectives. That is presumably the case with the EITC because of its socially desirable redistributive effects. But only after the magnitude of the provision's complexity is ascertained can policymakers determine whether that complexity is consistent with their policy goals.

Attractive complexity is not inherently benign because even if a related benefit makes a particular taxpayer whole, that benefit does not necessarily constitute a benefit to society. In the case of the EITC, the benefit to the individual from the income subsidy is presumed to provide a societal benefit by promoting values of self-reliance and autonomy. That societal benefit might be important enough to justify the costs of the EITC's complexity.

By contrast, the $100 of transactional complexity a taxpayer faces in creating a tax shelter produces no societal benefit. Even if the taxpayer has reason to view that $100 of complexity as beneficial because it produces tax savings of $101, $100 that could have been devoted to an economically productive use has still been spent on a tax shelter. In addition, $101 that could have been spent on school lunches, tax cuts for working families, or on the fight against terror, has instead been paid to a tax shelter investor as a tax benefit.

Producing an estimate of the impact of a tax rule change on the tax law's complexity that is useful for lawmakers requires, at the very least, a determination of the impact of that change on resource expenditures by

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45. *See supra* note 1 and accompanying text.

46. *See supra* note 27 and accompanying text. Slemrod does not expressly make the normative claim that complexity is undesirable because of its impact on resource use. He merely sees resource use as a proxy for complexity. *See id.* However, if we believe that complexity does in fact cause the tax law to consume scarce resources, it is reasonable to conclude that that is one reason to disfavor complexity and to value simplicity.

47. *See supra* note 18 and accompanying text.

taxpayers, unadjusted by all related tax benefits[48] and by most other benefits,[49] and on the government's resource expenditures. After making that determination, the algebraic sum of the estimated changes in resource expenditures by all relevant constituencies attributable to complexity would provide some indication of whether a change has simplified the law or made it more complex. Disregarding any significant resource cost, or overstating the importance of an insignificant cost, because taxpayers exhibit a preference for or against the complexity that gives rise to it, will produce a flawed result, preventing lawmakers from making an informed decision as to whether the complexity can be justified.

The same is true if the normative objection to tax complexity is not just a function of its impact on societal resources. For example, David Bradford explains that an important reason complexity is undesirable is that it prevents ordinary people from understanding how the tax law applies to others and can create suspicion and animosity among different groups of taxpayers:

> Complexity means different things to people in different economic circumstances. The "common man" may distrust the income tax system because it is so hard to understand. . . . The common man needs no more to understand the complicated tax law than to understand the complicated laws regulating banks. However, just as stories about $500 hammers weaken public confidence in the nation's defense system, stories about millionaires' and multinational corporations' taking advantage of special provisions of the law to eliminate their tax liabilities undermine support for the tax system. . . . [T]he law's complexity makes it easy for the common man to believe that "other

48. A related tax benefit is one produced by the tax system being reformed. If a federal income tax law change eliminated a $100 expense for taxpayers subject to a rule and a $50 cost for the federal government but caused new private and public expenditures of $150 and $50 respectively, the change would consume an additional $50 of resources. That is still true even if the change left taxpayers economically better off by reducing their aggregate federal income tax bill by $100.

49. Some of those benefits will constitute reductions in transactional complexity, and will already have been taken into account as reductions in complexity-related costs. That would be true, for example, if eliminating business meal substantiation rules permitted taxpayers to eat at their favorite restaurant even though it does not have the capacity to issue receipts. The decreased utility resulting from eating business meals at a disfavored restaurant would constitute transactional complexity and a cost of the substantiation rules. Other benefits, such as the creation of the more equitable after-tax distribution of income produced by the EITC, do not make the tax law any more or less complex. Likewise, payments to governments pursuant to regimes other than the tax system being reformed should not be taken into account. Taxpayers may not like paying state, local and foreign taxes and will certainly be made economically better off when they are able to avoid paying those taxes, but those payments are no more an indication of the federal income tax law's complexity than the amount of federal income tax a taxpayer owes.

people," especially the rich, are not paying their fair share.[50]

This effect, undermining the confidence of the "common man" in the fairness of the tax law, is no less powerful when the offending complexity is attractive rather than burdensome.

C. The Consumer Paradigm and Tax Deregulation

If not required to do so by law, it is unlikely that many taxpayers would often seek out the services of the IRS. Nevertheless, the government's actions, including its tax collection function, have increasingly come to be seen as services provided to the private sector that should be judged by the same standards applied to other services offered in the marketplace.[51] In the consumer paradigm, the objects of government action are viewed as the government's "customers" and the desirability of government action is judged "by the personal benefits"[52] those customers derive from the action.[53] The impact of this phenomenon on the tax law can clearly be seen in the advent of the taxpayer rights movement, which prompted the creation of an official taxpayer advocate charged with the responsibility of ensuring that the IRS treats taxpayers fairly.[54]

The rise of the consumer paradigm can be traced back to the 1970s deregulation movement.[55] Deregulation condemned "overzealous regulation"[56] that imposed excessive burdens on regulated industries. Eliminating burdensome regulation was intended to benefit regulated businesses and, indirectly, the public served by those regulated industries. Initially targeting regulatory regimes governing specific industries, such as the Civil Aeronautics Board and the Interstate Commerce Commission, the deregulatory agenda eventually expanded its focus to include regulatory bodies with broader mandates and a less clearly defined base of customers such as the Federal Trade Commission

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50. BRADFORD, *supra* note 21, at 4.

51. *See* COHEN, *supra* note 16, at 396-97 (noting evidence that "consumer/citizens . . . increasingly related to government itself as shoppers in a marketplace").

52. *Id*. at 397.

53. *Id*. at 396.

54. The position of taxpayer ombudsman was created in 1979 and in 1996 was renamed the "taxpayer advocate." *See* Marjorie E. Kornhauser, *When Bad Things Happen to Good Taxpayers: A Tale of Two Advocates*, 16 TAX NOTES INT'L 537, 537 (1998).

55. Cohen sees a common thread in the deregulation movement of the 1970s and efforts during the 1980s and 1990s to make government more entrepreneurial. *See* COHEN, *supra* note 16, at 391-96. That common thread is a focus on reducing the ratio of the burden government imposes on the private sector to the benefits it provides. *See id*.

56. *Id*. at 391.

and the Environmental Protection Agency.[57] By the end of the 1970s, the broad impact of deregulation was already clearly evident.[58] During the 1980s, the IRS came to be viewed as just one more regulator whose substantive and procedural rules imposed excessive burdens on taxpayers, limiting the "economic freedom" of those subject to its rules.[59]

The consumer paradigm offers an account of why tax complexity is undesirable that is distinct from the orthodox focus on preserving scarce societal resources. The consumer paradigm suggests that the preferences of taxpayers are paramount. As a result, the key harm produced by tax complexity is thought to be its impact on taxpayers subject to the complexity. Taxpayers will tend to see tax complexity as a government-imposed burden and will generally seek to eliminate it in order to improve their economic well-being.

The critical difference between the two competing visions of complexity is that all complex tax rules will consume resources, but not all complex rules will reduce taxpayers' economic well being. When forming a preference regarding a complex tax rule, taxpayers will consider both the economic costs the rule will impose on them and the benefits the existence of the rule will provide. For example, the EITC consumes large amounts of resources yet is consistent with the preferences of the taxpayers required to understand and comply with its rules.[60] This is true because taxpayers derive a benefit from the existence of the EITC (e.g., a $100 tax refund) that more than outweighs its cost in resources (e.g., $25 in out-of-pocket expenditures).[61] This matters not merely because $25 worth of resources may be wasted, but also because the efficacy of the policy underlying the EITC is directly undermined by the existence of the complexity. What was intended to be a $100 wage subsidy is reduced to only $75.

Tax reforms that distinguish between complexity that taxpayers

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57. *See id.*

58. "We've deregulated rail, deregulated trucking, deregulated airlines, deregulated financial institutions, working on communications, to make sure that we have a free enterprise system that's competitive, so that the customers get a better deal and the business community gets a better deal as well." *Id*. at 393 (quoting remarks by President Carter in 1980).

59. *Id*. at 395. Deregulation promises benefits to the public by freeing businesses from burdens imposed by government action. In that way, it is something of a regulatory analog of supply-side fiscal policies. Deregulation and supply-side economic policies advance the public welfare by fostering autonomy and liberating the private sector from burdensome regulation on the one hand and the burden of high taxes on the other.

60. Home ownership tax incentives are another example of provisions that can create significant amounts of complexity but that taxpayers perceive as beneficial because they are the result of rules that generate significant tax benefits. *See supra* note 32 and accompanying text.

61. *See supra* note 35 and accompanying text.

find appealing and complexity that taxpayers find burdensome may be called tax simplification but are really tax deregulation. Because their focus is on private benefits and burdens rather than on systemic objectives, such as preserving societal resources, such deregulatory reforms will sometimes give rise to changes that have undesirable systemic consequences such as increasing waste. That would be the case, for example, if the passive loss rules were eliminated and taxpayers devoted $100 to developing tax shelter investments that produced tax savings of $150 while saving taxpayers $75 that would have been spent complying with the passive loss rules. That change would result in an additional $25 being devoted to the tax law. However, the taxpayers would be better off (-$100+$150+$75=$125). Even those taxpayers subject to an increased amount of complexity would be economically better off (-$100+$150=$50) than they were before the change.

There are two fundamental reasons that a deregulatory reform will not always be a simplifying reform, both of which derive from the consumer paradigm's singular focus on the preferences of taxpayers. First, because the primary concern is the taxpayer, the consumer of the government's tax services, burdens imposed on taxpayers are emphasized at the expense of those faced by other constituencies, including the government. In addition, taxpayers may be willing to make trade-offs such as accepting a $150 tax benefit at the price of $100 in transactional complexity.

D. The Check-the-Box Election

The irony of the check-the-box regulations is that although they did much to simplify the entity classification rules, that simplification was not primarily a product of their signature feature: the check-the-box election. The check-the-box election transformed entity classification by replacing a mandatory regime, in which classification was a function of the economic and legal characteristics of an entity, with one that generally permits taxpayers to choose the classification of entities. However, the election played a relatively minor and largely serendipitous[62] role in addressing the complexity that had plagued the

62. Prophylactic elections have a simplifying effect only because the election was made available to foreign, as well as domestic, entities. *See infra* text accompanying notes 201-03. Notice 95-14 makes clear that when the election was first announced it was intended primarily as a domestic reform. *See* Notice 95-14, *supra* note 9, at 298. That the election was to be made available to foreign, in addition to domestic, entities was not a foregone conclusion. *See id.* ("Because the complexities and resources devoted to classification of domestic unincorporated business organizations are mirrored in the foreign context, the Service and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the

pre-1997 rules. As described below, that complexity was a product of the remarkable entity classification regulations put in place in 1960 and could have been addressed without the creation of the check-the-box election and its elective system of classification.

III. ENTITY CLASSIFICATION BEFORE AND AFTER THE CHECK-THE-BOX REGULATIONS

The check-the-box regulations provide a unique opportunity to evaluate the impact of a consumer paradigm focus on taxpayer preferences on the tax law's complexity. It is the perfect "real world" experiment. The check-the-box regulations were created expressly and exclusively as a simplification measure[63] and built from the ground up in a radical break from prior law by the Clinton Administration's top tax policy experts with extensive commentary from some of the nation's leading private-sector tax specialists. Proposed as part of an effort to ease the burden placed on taxpayers by federal regulations,[64] the regulations were premised on the notion that simplification was an effective means of reducing taxpayer burdens. Understanding the ways in which the experiment failed reveals the pitfalls of treating attractive complexity as benign.

The key failure of the check-the-box regulations is that they, in large part due to the introduction of the check-the-box election, may have done at least as much to complicate the tax law as they did to simplify it. Although the check-the-box election did simplify as intended—for example by reducing the transactional complexity associated with classification changes[65]—it also produced considerable complexity. It did so in a number of ways, including relatively minor ones like creating new compliance burdens.[66] More importantly, the existence of the check-the-box election raised a host of new and difficult questions for taxpayers, their advisors and the government to answer.[67]

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approach described above for domestic organizations."). Had check-the-box elections been available only to domestic entities, one of its two primary simplification benefits would not have been realized.

63. *See generally* Notice 95-14, *supra* note 9.

64. *See infra* note 271 and accompanying text.

65. *See infra* notes 205-08 and accompanying text.

66. The best example of this is the contemporaneous filing requirement for making a classification election. *See* T.D. 8697, 1997-1 C.B. 218, § C. Taxpayers unsuccessfully objected to the contemporaneous filing requirement as needlessly burdensome. *See id.*

67. *See infra* notes 249-52 and accompanying text.

A. Entity Classification Before the Check-the-Box Regulations

The mandatory rules that the check-the-box regulations replaced were, by any yardstick, extremely complex. Those regulations governed the tax distinction between unincorporated entities that the tax law treated as corporations and unincorporated entities the tax law treated as partnerships for almost four decades. This Section describes the origins of the prior rules, known as the four-factor test, and examines their impact on the tax law. An ill-conceived tax rule that spectacularly failed to achieve its aim of preventing a specific form of tax planning,[68] the four-factor test ultimately facilitated far more tax planning than it ever prevented. This Section also discusses the role the limited liability company played in drawing attention to the shortcomings of the four-factor test.

1. The Resemblance Test

In December of 1996, the Treasury Department replaced the regulations governing the tax classification of business entities with the check-the-box regulations, at the time described as a "dramatic and innovative"[69] set of rules. In doing so, it set aside regulations introduced in 1960 that represented an earlier deliberate transformation of the process of entity classification.

The 1960 regulations brought significant changes to the entity classification regime, but preserved a key aspect of the pre-1960 framework: the mandatory classification system that had been a part of the modern income tax since its inception.[70] From 1909 until the check-the-box regulations went into effect in January of 1997, non-elective classification rules determined which entities[71] would be corporations for federal income tax purposes, and therefore subject to the corporate income tax, and which would not. Those rules were premised on the

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68. *See infra* notes 87-90 and accompanying text.

69. NYSBA TAX SECTION, REPORT ON THE "CHECK THE BOX" ENTITY CLASSIFICATION SYSTEM PROPOSED IN NOTICE 95-14, Part I, *reprinted in NYSBA Strongly Endorses Check-the-Box Entity Classification Proposal*, TAX NOTES TODAY, Sept. 5, 1995, at 173-74 [hereinafter NYSBA 1995].

70. The unequal treatment of partnerships and corporations predates the 1913 ratification of the 16th Amendment. *See* U.S. CONST. amend. XVI. It is rooted in the 1909 decision to tax corporations but not partnerships. The Revenue Act of 1909, ch. 6, § 38, 36 Stat. 112, 112-13 (1909). By contrast, the income tax introduced during the Civil War taxed both partnerships and corporations. *See* Stephen B. Scallen, *Federal Income Taxation of Professional Associations and Corporations*, 49 MINN. L. REV. 603, 610 (1965).

71. An entity may be deemed to exist for tax purposes regardless of whether an entity exists under state law. Treas. Reg. § 301.7701-1(a)(2) (1996). For purposes of this Article, any reference to an entity includes such constructive entities.

notion that it was necessary, or at least appropriate, for the tax treatment of an entity to be dependent on that entity's economic and legal characteristics.

As discussed below, under the pre-1997 mandatory entity classification regime commonly referred to as the resemblance test,[72] entity characteristics such as the extent to which an owner would be held liable for the entity's debts determined a given entity's tax treatment. The resemblance test ignored taxpayer intent and other arguably relevant criteria,[73] except as they were reflected in the features deemed relevant. Although the resemblance test changed significantly in 1960 and many times in more subtle ways,[74] prior to 1997 its reliance on objective entity traits to determine that entity's tax treatment remained consistent. Only the 1996 regulations set aside the resemblance test's insistence on an analysis of an entity's non-tax attributes and a mandatory classification flowing from those attributes.

In 1935, the Supreme Court's opinion in *Morrissey v. Commissioner*[75] provided the classic formulation of the long-lived resemblance test.[76] *Morrissey* embraced the broad interpretation of the term "association" endorsed in an earlier Supreme Court opinion[77] that captured unincorporated business organizations similar to state law corporations even though they were "common law" rather than statutory corporations.[78]

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72. Although they are in fact quite different, the term "resemblance test" is often used to refer to both the pre- and post-1960 classification rules.

73. *See, e.g.*, Joseph A. Snoe, *Entity Classification Under the Internal Revenue Code: A Proposal to Replace the Resemblance Model*, 15 J. CORP. L. 647, 649 (1990) (identifying "member participation in the organization and the nature of the organization's business or investment activities as the critical factors in classifying the organization").

74. *See, e.g.*, William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe to Go Back in the Water)*, 1 FLA. TAX REV. 197, 199-205 (1993) (describing developments in the administration of a four-factor test through the early 1990s); Scallen, *supra* note 70, at 653-66 (exhaustively reviewing the development of the classification regulations between 1894 and 1941).

75. 296 U.S. 344, 360 (1935) (finding a state law trust had characteristics that closely resembled those of a corporation and was therefore an association taxable as a corporation).

76. *Morrissey* also used the word "resemblance" to describe the required relationships among unincorporated entities classified as associations, and therefore treated as corporations, giving the resemblance test its name. *Id*. at 357 (noting the statute's consistent treatment of associations and corporations "implies resemblance; but it is resemblance and not identity").

77. *See* Hecht v. Malley, 265 U.S. 144, 156 (1924) (finding no requirement that associations be organized under a state association law). Associations are business entities not possessing a state-issued corporate charter, but that are subject to the corporate income tax on the principle that state law distinctions are not determinative for federal income tax purposes and that such an entity "although unincorporated, transacts business as if it were incorporated." Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 114 (1925).

78. *Hecht*, 265 U.S. at 155.

The tax statute at issue in *Morrissey* defined the term corporation to include associations, but failed to define the term association. As a result, the term association became a catch-all classification and, as with the trust at issue in *Morrissey*, entities sufficiently resembling corporations became associations and therefore de facto corporations for tax purposes. *Morrissey*'s expansive application of the corporate income tax to entities other than state law corporations was consistent with the approach of the early regulations.[79] In practical terms, the pre-1960 resemblance concept represented an application of the principle underlying the early law of entity classification that would be familiar to any modern tax lawyer: in distinguishing corporations from other entities, substance trumps form so that entities possessing the attributes of a corporation are taxed as corporations.[80]

Through the 1950s, that substance-over-form resemblance concept remained central to the classification of entities for tax purposes.[81] Importantly, although the same concept that informed *Morrissey* formed the core of the pre-1960 entity classification regulations, the pre-1960 regulations made no attempt to mimic the language of the *Morrissey* opinion.[82] The relationship between *Morrissey* and the association regulations changed in 1960. Unlike earlier regulations, the 1960 regulations meticulously employed language from the *Morrissey* opinion.[83] However, they did so while abandoning the pro-association, substance-over-form orientation of both *Morrissey* and the pre-1960 regulations.[84]

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79. The 1914 regulations specified that although partnerships were generally excluded from the income tax: "Limited partnerships are held to be corporations within the meaning of this act and these regulations, and in their organized capacity are subject to the income tax as corporations." Treas. Reg. 33, art. 86 (1914), *reprinted in* Scallen, *supra* note 70, at 654 n.261.

80. *See Morrissey*, 296 U.S. at 360 ("[A]ttributes make the trust sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of corporations.").

81. *See, e.g.*, Treas. Reg. § 39.3797-5(a) (1953) ("A limited partnership is classified for the purpose of the Internal Revenue Code as an ordinary partnership, or, on the other hand, as an association taxable as a corporation, depending upon its character in certain material respects.").

82. *See* H. Lawrence Fox, *The Maximum Scope of the Association Concept*, 25 TAX L. REV. 311, 313 (1969) ("The 1960 regulations differed from the 1953 regulations in that the basic pattern is more of a copy of the *Morrissey* opinion than its predecessor.").

83. For example, the 1960 regulations listed six characteristics to be used to identify associations. Those six characteristics are not listed in the 1953 regulations. Although several of the same concepts, including the notion that corporations are managed by designated representatives of the owners, appear in both sets of regulations, only the 1960 regulations mimic phrases such as "centralized management." *Morrissey*, 296 U.S. at 359.

84. Treasury may have been concerned that its substantive changes to the entity classification rules would be viewed as an unconstitutional attempt to overrule the Supreme Court's *Morrissey* opinion. That concern could have led Treasury to draw attention away from those substantive changes by emphasizing superficial similarities, including the use of similar words and phrases,

2. The 1960 Regulations

The controversy that produced *Morrissey* exemplifies the typical classification struggle between taxpayers and the government. In *Morrissey*, taxpayers unsuccessfully fought to avoid the imposition of the corporate tax on an unincorporated entity.[85] Until 1960, the classification rules were principally designed to defeat such attempts by maintaining a bias in favor of corporate treatment.[86] However, because of the pervasive reach of a classification determination and the dynamic nature of the tax law, corporate treatment has at times meant more to taxpayers than simply an extra layer of tax. Sometimes taxpayers affirmatively seek, instead of avoid, corporate treatment.

In *United States v. Kintner*,[87] a taxpayer turned the tables on the government. In order to take advantage of tax-favored pension rules at that time only available to corporations, Dr. Kintner sought to form an entity that would be classified as a corporation for tax purposes while remaining a partnership for state law purposes.[88] For this taxpayer and for other professionals in similar situations, the government's broad success in preserving the corporate tax base by creating a bias in favor of classification as a corporation provided a planning opportunity. The government ultimately responded to its loss in *Kintner* by issuing revised classification regulations in 1960.[89] Those regulations made it more difficult for taxpayers to achieve corporate tax status for unincorporated entities, including partnerships.[90]

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between the 1960 regulations and *Morrissey*. Recent scholarship has explored the possibility that this same concern inspired the government to craft the 1996 entity classification regulations in a pro-taxpayer fashion to preclude the possibility of such a constitutional challenge. *See* Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185 (2004).

85. The taxpayers in *Morrissey* were trustees of a trust that unsuccessfully fought to avoid the imposition of income taxes on that trust, asserting that the trust had been "illegally treated as an 'association'" by the government. *Morrissey*, 296 U.S. at 346.

86. *See, e.g.*, Scallen, *supra* note 70, at 709 ("For 50 years the regulations consistently tended to classify borderline cases as associations.").

87. 216 F.2d 418 (9th Cir. 1954).

88. Kintner and his colleagues were physicians prohibited from organizing their medical practice as a corporation under state law. *See id*. at 421.

89. T.D. 6503, 25 Fed. Reg. 10,928 (1960); *see also* Brannan, *supra* note 74, at 202 (noting that regulations' "bias [towards partnership classification] arose because at one time many professional service businesses operated in partnership, trust or association form, but claimed that they were taxable as corporations in order to become entitled to the favorable tax benefits that were available for corporate pension and profit-sharing plans"); Fox, *supra* note 82, at 313 ("[T]he publication of the 1960 regulations must be viewed as a policy decision to administratively overrule *United States v. Kintner*."). The relationship of the regulations to *Kintner* was no secret. They were often referred to as the *Kintner* regulations. *See, e.g.*, Scallen, *supra* note 70, at 604-05.

90. "No matter how the [1960] regulations are read, the bias toward partnership classification is unmistakable." Richard A. Fisher, *Classification Under Section 7701—The Past, Present and Prospects for the Future*, 30 TAX LAW. 627, 630 (1977).

The structure of the 1960 regulations differed significantly from earlier association regulations. For example, the regulations they replaced contained a broad rule describing associations, a narrower provision distinguishing partnerships from associations and additional guidance targeted at specific types of unincorporated entities, including limited partnerships.[91] The 1960 regulations abandoned this tiered system in favor of a single mechanism to be used to identify all unincorporated entities required to be classified as associations. That mechanism listed six corporate characteristics to be used in identifying associations.[92] Of the six criteria, the regulations further specified that four were relevant to the distinction between partnerships and associations.[93] This aspect of the post-1960 entity classification regime, distinguishing associations taxed as corporations from partnerships, was known as the "four-factor" test.

Like an avant-garde artist intent on realizing his vision using only found objects,[94] the drafters of the 1960 regulations assiduously avoided introducing new concepts into their work. Instead, the 1960 regulations borrowed from *Morrissey*, the principal authority on the association question. Although the 1960 regulations represented a fundamental shift in the operation of the entity classification regime, replacing a pro-association bias with an anti-association bias, the new rules were constructed largely out of artfully assembled *Morrissey* elements.[95]

Had it been presented with a clean slate, it is hard to imagine that limited liability, free transferability of interests, continuity of life and centralized management would be the four criteria the government would choose to reverse its loss in *Kintner* by making corporate tax treatment more difficult to achieve. After all, these factors were among the criteria that the Supreme Court and the prior regulations employed to

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91. *See* Treas. Reg. § 39.3797-5 (1953).

92. The 1960 regulations specify "(i) Associates, (ii) an objective to carry on business and divide the gains therefrom, (iii) continuity of life, (iv) centralization of management, (v) liability for corporate debts limited to corporate property, and (vi) free transferability of interests" as the six characteristics of a "pure Corporation." Treas. Reg. § 301.7701-2(a)(i) (1960). The regulations also make reference to "other factors" that may sometimes be relevant. Treas. Reg. § 301.7701-2(a)(1) (1960). The references to other factors never had much of an impact. *See* Brannan, *supra* note 74, at 201.

93. "Since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships," partnership or association classification depended on the other four factors. Treas. Reg. § 301.7701-2(a)(2) (1960).

94. Joseph Cornell, the mid-20th century "American progenitor of found-object art," created his famous "shadowboxes" using "reclaimed" materials such as toys, photographs, glasses, prints, cutouts of movie stars. WAYNE CRAVEN, AMERICAN ART: HISTORY AND CULTURE 596-97 (2003).

95. The 1960 regulations were recognized as an intentional, if superficial, copy of *Morrissey*, in a way very different from the pre-1960 regulations. *See supra* note 82 and accompanying text.

make corporate classification difficult for entities like the trust at issue in *Morrissey* to escape, and easy for Dr. Kintner's partnership to attain. To realize their aim of making corporate tax classification less readily available, the 1960 regulations compensated for the perceived constitutional constraints *Morrissey* imposed on its choice of factors[96] with creativity in their presentation of those factors.

The organizational principle employed by the four-factor test was the preponderance test. The preponderance test required that an unincorporated entity possess three out of the four factors in order for it to be classified as an association.[97] Implicit in the mathematics of the test was the presumption that each of the factors deserved equal weight.[98] The preponderance test, an aspect of the 1960 regulations without clear historical roots,[99] made corporate classification more difficult to achieve than *Morrissey* would seem to require. The preponderance test was important to making partnership tax treatment broadly available to unincorporated entities, but it was not the principal cause of the bias shift.[100]

Although the four factors were borrowed from *Morrissey*,[101] the drafters of the 1960 regulations permitted themselves considerable latitude in interpreting them. They used that flexibility to make each factor difficult to satisfy for those seeking corporate treatment (which also made them easy to avoid for those seeking partnership treatment). In stark contrast to the 1953 regulations, the 1960 regulations provided lengthy and detailed discussions of the circumstances in which an entity

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96. *See supra* note 84.

97. Treas. Reg. § 301.7701-2(a)(3) (1960) (stating that an "unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than non-corporate characteristics").

98. *See* Scallen, *supra* note 70, at 694 ("Why two out of the four noncorporate characteristics requires classification as a partnership, rather than as an association, is not explained. Nowhere is justification given for applying each criterion as though it had weight equal to the others.").

99. *See id.* ("The [preponderance] approach of . . . the [1960] Regulations is not supported by either the cases or the early regulations.").

100. Prior regulations had used something similar to the preponderance test by requiring a specific combination of three of four characteristics that can be loosely analogized to the four factors for corporate classification. *See, e.g.*, Treas. Reg. § 39.3797-5(a) (1953) (classifying limited partnerships as associations if they possessed (i) centralized management and (ii) either free transferability of interests (a change in the ownership of the general partner's participating interest did not "interrupt" the partnership) or continuity of life (the death of the general partner did not "interrupt" the partnership)).

101. The drafters of the 1960 regulations went so far as to actually include a citation to *Morrissey* in the text of the regulations. *See* Treas. Reg. § 301.7701-2(a)(1) (1960) ("An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust.") (citing Morrissey v. Comm'r, 296 U.S. 344 (1935)).

would possess or lack each of the four factors.[102]

For example, the 1953 regulations provided that a limited partnership possessed what the 1960 regulations refer to as "continuity of life" if "the organization is not interrupted by the death of a general partner . . . ."[103] Just the first sentence of the comparable provision of the 1960 regulations stated that an "organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization."[104] The goal of this more detail-oriented approach was to "refer to anything in local law, agreements, legal relationships of the members among themselves and with the public, and ethics of a professional group, which, however slightly, differs from a typical business corporation, and then to magnify that slight difference into a rule compelling classification as a partnership."[105] In other words, the 1960 version of the test for continuity of life was intentionally designed to be easy to flunk.

Morrissey may have provided the starting point for the creation of the four factors, but it was hardly a blueprint for the four-factor test. The effort to make the four-factor test easy to fail transformed the factors from their simple pre-1960 form into highly complex rules.[106] The four factors invited much discussion and comment,[107] but after more than three decades even the most insightful commentators could only catalogue the lingering uncertainties produced by the four factors.[108]

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102. Treas. Reg. § 301.7701-2(b)-(e) (1960).

103. Treas. Reg. § 39.3797-5(a) (1953).

104. Treas. Reg. § 301.7701-2(b)(1) (1960). The references to insanity and dissolution were not drawn from *Morrissey*, but from a 1942 Board of Tax Appeals decision. *See generally* Glensder Textile Co. v. Comm'r, 46 B.T.A. 176 (1942).

105. *See* Scallen, *supra* note 70, at 695. This approach tended to create absurd results. As one pair of commentators put it, allowing "tax treatment to turn on whether advisors have sufficiently imposed restrictions on transfer of ownership interests or have provided for dissolution of an entity when one of the members becomes insane seems a strange way to divide the tax world." William A. Klein & Eric M. Zolt, *Business Form, Limited Liability, and Tax Regimes: Lurching Toward a Coherent Outcome?*, 66 U. COLO. L. REV. 1001, 1012 (1995) (observing that the regulations tended to overstate the significance of highly technical, and easily manipulated, terms of a business arrangement).

106. *Compare* Treas. Reg. § 39.3797-5(a) (1953) (treating all limited partnerships as exhibiting limited liability, merely by virtue of being limited partnerships), *with* Treas. Reg. § 301.7701-2(d) (1960) (containing a convoluted description of what constituted limited liability relying on concepts such as "dumm[iness]").

107. *See, e.g.*, Brannan, *supra* note 74; Fox, *supra* note 82, Fred W. Peel, *Definition of a Partnership: New Suggestions on an Old Issue*, 1979 WIS. L. REV. 989; Scallen, *supra* note 70.

108. *See, e.g.*, Brannan, *supra* note 74 (noting many lingering unresolved issues related to the four factors). Descriptions of the four-factor test as a "self-constructed maze," Fox, *supra* note 82, at 362, convey a sense of the bewilderment engendered by the 1960 regulations. That bewilderment was presumably less pleasant than, but perhaps not much different from, the experience of viewers of found-object art like Cornell's shadow boxes. *See* CRAVEN, *supra* note 94, at 596-97 (noting that

Although the 1960 regulations extracted the names of the four factors almost verbatim from *Morrissey*, in some cases it could be difficult to see what relationship the result of an application of the four-factor test had to the original *Morrissey* resemblance concept.[109] More importantly, it could be difficult to understand what relationship any particular classification determination bore to any useful tax policy objective.[110]

The four factors, with the help of the preponderance test, managed the remarkable feat[111] of using language and concepts from *Morrissey* to make corporate classification more difficult to achieve. Unfortunately, thanks to accommodating state legislatures, the four-factor test was an instant failure.[112] By creating new types of entities that permitted taxpayers like Dr. Kintner to bypass the anti-association bias of the four-factor test by incorporating, the states made the federal tax benefits of corporate classification available to professionals.[113]

The 1960 regulations, effectively obsolete shortly after their creation, nevertheless became an important feature of the tax landscape. Taxpayers relied on the four-factor test to avoid corporate classification when avoiding a corporate-level income tax was advantageous.[114] But, however beneficial the four-factor test proved to be for taxpayers, it was not simple.

"[a]lthough viewers may have difficulty comprehending the meaning of the assembled objects, they usually find pieces like [Cornell's shadowboxes] intriguing and enjoyable").

109. The inconsistency of the 1960 regulations with *Morrissey* can be illustrated by taking a hypothetical entity possessing five of *Morrissey*'s original seven characteristics (any two of the four factors, plus associates and a business purpose, along with the seventh *Morrissey* corporate characteristic: "centralization of title"). Such an entity would not be classified as an association under the 1960 regulations, simply because it lacked two of four factors highlighted by the 1960 regulations.

110. *See* Klein & Zolt, *supra* note 105, at 1010-13.

111. *Morrissey* was, of course, the case that first fully articulated the substance-over-form resemblance concept requiring entities displaying corporate characteristics to be treated like corporations for tax purposes. Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518, 521 (1996). Constructing a pro-partnership bias out of the language of a pro-association opinion is no small achievement.

112. State legislatures intervened, enacting statutes permitting professionals to form special types of statutory corporations. *See* Boris I. Bittker, *Professional Associations and Federal Income Taxation: Some Questions and Comments*, 17 TAX L. REV. 1 (1961).

113. Regulations issued in 1965 intended to counter these state laws were rejected by the courts as arbitrary. *See* Kurzner v. United States, 413 F.2d 97, 106 (5th Cir. 1969).

114. *See* Fox, *supra* note 82, at 364 (stating that taxpayer's ability to effectively choose their classification remained a feature of the classification regime through the mid-1990s); Klein & Zolt, *supra* note 105, at 1011 (observing that a "well-advised taxpayer whose sole concern is avoiding corporate classification can escape corporate classification with relative ease").

3. The Complexity of the 1960 Regulations

A well-advised taxpayer could use the four-factor test, with its pro-partnership bias, to avoid the imposition of a corporate-level tax as a matter of course. Nevertheless, doing so was typically an expensive proposition. That expense was a product of the rule and transactional complexity created by the 1960 regulations.

Rule complexity, a function of the difficulty of understanding the four-factor test and what it required with respect to any given entity, could require taxpayers to pay considerable sums to sophisticated tax counsel for classification advice.[115] The outcome of the test could turn on everything from the circumstances in which the existence of the entity would terminate, even in a purely technical sense,[116] to the organization of the entity's management structure.[117] Commentators noted that this made it costly to understand how the four factors would apply to a particular set of facts in order to minimize the "residual risk that the [Internal Revenue] Service might claim that some partnership factor is not satisfied for some technical reason . . . ."[118] The four factors "require[d] legal judgments based upon subtle distinctions" and, because the facts on which those legal judgments turned varied across jurisdictions and industries, even issues taxpayers could expect to encounter regularly often had not been addressed by official guidance.[119]

In addition to the out-of-pocket costs reflecting the regulations' rule complexity, taxpayers seeking to escape the corporate tax by relying on the four-factor test also incurred costs arising from the limitations the four-factor test imposed on taxpayers' freedom to structure their business arrangements in their preferred manner.[120] To signal their intent that a business entity be taxed as a partnership rather than a corporation, for example, taxpayers would need to draft the entity's operative legal documents so that the entity possessed no more than two of the four factors. Critics observed that, while not typically difficult to satisfy, this requirement inevitably resulted in undesirable distortions of legal and

115. *See* NYSBA 1995, *supra* note 69, Part III.A ("[T]he current entity classification system imposes substantial compliance costs on taxpayers, both in terms of the resources required to address entity classification issues and the effect of the uncertainties in the law."); Michael L. Schler, *Initial Thoughts on the Proposed 'Check-the-Box' Regulations*, 71 TAX NOTES 1679, 1681 (1996) (identifying decreased out-of-pocket taxpayer costs as one of the "primary benefits" of elective system).

116. Treas. Reg. § 301.7701-2(b)(1) (1960).

117. Treas. Reg. § 301.7701-2(c) (1960).

118. Schler, *supra* note 115, at 1681.

119. NYSBA 1995, *supra* note 69, Part III.A.

120. *See* Klein & Zolt, *supra* note 105, at 1013 (questioning whether tax law should "force taxpayers to adopt awkward or inefficient forms of organization or methods of operation merely to reduce tax liability").

commercial relationships.[121] Because the presence or absence of the four factors was determined by reference to the actual legal rights taxpayers possessed under state law[122] real, if often nonsensical,[123] changes in legal rights were necessary to add or eliminate a factor. The inefficiencies associated with those distortions were a form of transactional complexity that constituted a second, hidden cost of the four-factor test.

At a superficial level, the 1960 regulations appeared to be a neutral refinement of the prevailing *Morrissey* resemblance test. Nevertheless, it is clear that the regulations were specifically crafted to frustrate tax planning by taxpayers seeking to qualify for favorable pension and other provisions available only to corporations.[124] That effort transformed the entity classification rules, particularly the aspect of those rules distinguishing partnerships from corporations, from an unremarkable substance-over-form rule into a complex regime that was "the living embodiment of form over substance."[125]

It is certainly possible that even a sincere attempt to articulate a set of rules of general application that would reliably distinguish all business entities into two groups, one group meaningfully resembling "pure" corporations and the other partnerships, would inevitably be highly complex because of a lack of conceptual coherence in the distinction between corporations and partnerships.[126] However, given that pre-1960 regulations were significantly less complex than the four-factor test, complex mandatory rules do not seem to be inevitable.[127]

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121. NYSBA 1995, *supra* note 69, Part III.A (noting that the four-factor test requirements adversely affected management structure, transferability of interests in the entity and exposure to liabilities).

122. Treas. Reg. § 301.7701-1(c) (1960) ("Although it is the Internal Revenue Code rather than local law which establishes the tests or standards . . . local law governs in determining whether the legal relationships which have been established in the formation of an organization are such that the standards are met.").

123. *See supra* note 105 and accompanying text.

124. *See supra* note 89.

125. Fox, *supra* note 82, at 315.

126. It has been implied that the complexity of the 1960 regulations was a function of the naiveté of their creators in assuming that the platonic essence of the corporate form could be reduced to a few corporate characteristics and used to distinguish between partnerships and corporations. *See, e.g.*, David A. Weisbach, *Line Drawing, Doctrine, and Efficiency in the Tax Law*, 84 CORNELL L. REV. 1627, 1644 (1999) ("The terms 'corporation' and 'partnership,' however, do not clearly refer to common ideas, particularly at the boundaries of these categories. Instead of clarity, platonic reasoning only creates complexity and avoidance opportunities. The platonic approach fails on theoretical grounds (because it is not tied to values we care about) and on practical grounds (because the words themselves are inherently unclear).").

127. The 1914 regulations, for example, dispatch with the problem of classifying limited partnerships by making all limited partnerships corporations. *See* Treas. Reg. 33, art. 86 (1914).

4. Three Decades of Four Factors

The four-factor test survived for more than thirty years after the creation of professional corporations rendered the test's intricately constructed anti-corporate bias moot. Despite several attempts to revise the entity classification regulations, the four-factor test gradually evolved from a nuisance into fuel for the tax shelter boom of the 1980s. Although the limited liability company "revolution"[128] of the early 1990s, like the limited partnership's rise from obscurity during the 1960s and 1970s, capitalized on the four-factor test's broad grant of partnership tax status rather than on any fundamental weakness in the resemblance test's mandatory classification scheme, the eventual collapse of the four-factor test took the resemblance test with it.

When it issued Notice 95-14, announcing its intention to replace the four-factor test, the government explained why the time had arrived to eliminate the resemblance test. Notice 95-14 anchored its proposal to abolish the resemblance test on the idea that the creation of entities like the limited liability company represented a "narrowing of the differences under local law between corporations and partnerships" that made it possible for taxpayers to "achieve partnership tax classification for a non-publicly traded organization that, in all meaningful respects, is virtually indistinguishable from a corporation."[129] The Notice concludes that the limited liability company, among other entities, afforded taxpayers a new flexibility to combine corporate entity traits like limited liability with partnership tax treatment, posing a new threat to the resemblance test's objective of sorting partnerships from associations.

The flaw in the Notice's reasoning is that it sees a particular result, partnership tax classification for near-corporate entities like limited liability companies, as evidence of a newly dysfunctional process. But that result was not a product of a malfunction or a lack of precision. Partnership tax classification for near-corporate entities was exactly what the four-factor test was designed to achieve. It is undoubtedly correct that changes in the state law of business entities[130] raised interesting theoretical questions with regard to the overall coherence of the link between specific forms of business entity and limited liability.[131]

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128. Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 395 (1996).

129. Notice 95-14, *supra* note 9, at 297.

130. The Notice cites two examples of those changes: (1) the modification of some state partnership statutes "to provide that no partner is unconditionally liable for all debts of the partnership" (presumably referring to the enactment of limited liability partnership statutes); and (2) the nationwide spread of limited liability companies. *Id*.

131. *See, e.g.*, Klein & Zolt, *supra* note 105, at 1036 (concluding "limited liability should not turn on choice of business form—not now, not ever").

However, the fact that taxpayers could employ limited liability companies to combine limited liability with partnership tax treatment did little to distinguish limited liability companies from limited partnerships,[132] an entity as old as the modern income tax.[133]

The limited partnership existed long before the issuance of the 1960 regulations, but prior to 1960, its usefulness was limited.[134] The 1960 regulatory changes to the resemblance test, creating the new pro-partnership bias, significantly reduced the obstacles to limited partnerships qualifying for partnership tax treatment. In the years that followed, taxpayers made the most of the opportunity created by the 1960 regulations by breathing new life into the limited partnership.[135] Over time, the incentive for taxpayers to capitalize on the 1960 regulations' bias would only grow.[136] By the 1970s, the government began trying to moderate that bias. The first attempt came in 1977.

The 1977 proposal retained both the resemblance concept and the *Morrissey* corporate characteristics.[137] The proposed regulations sought

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132. *See* Brannan, *supra* note 74, at 261. Brannan observed in 1993, that

> [o]ne might be tempted to say that we are effectively moving towards an elective, "check the box" type of entity classification scheme. However, to a large extent the current state of the partnership classification law is simply a product of the literal language of the four factor test . . . which we have been living with since 1960.

Id.

> [E]ven before the rise of LLCs, the present system gave taxpayers a choice of action on minimizing tax liability. Taxpayers could structure their affairs to be subject to a single-level tax under partnership or S corporation tax regimes . . . LLCs make this elective system more widely and more inexpensively available.

Klein & Zolt, *supra* note 105, at 1012.

133. The original Uniform Limited Partnership Act was promulgated in 1916. Early entity classification rules dealt expressly with the treatment of limited partnerships. *See* Treas. Reg. 33, art. 86 (1914).

134. Soon after the issuance of the 1960 regulations, one practitioner observed that while "use of the limited partnership as a business organization" was not uncommon before the 1960 regulations were introduced, its use was limited to situations "where it can sustain partnership classification." Marvin Lyons, *Comments on the New Regulations on Associations*, 16 TAX L. REV. 441, 460 (1961).

135. Commentators note the increasing popularity of limited partnerships following the adoption of the four-factor test. Some situate the rise in popularity as taking place in the 1960s. *See, e.g.*, Klein & Zolt, *supra* note 105, at 1003 ("[L]awyers seeking to qualify enterprises as partnerships for tax purposes without sacrificing the limited liability associated with the corporate form found (beginning in the 1960s) that they were able to take advantage of a previously dormant form of organization, the limited partnership."). Others place the limited partnership's surge in popularity in the 1970s. *See, e.g.*, NYSBA 1995, *supra* note 69, Part II.B (noting "increased use of the limited partnership form of conducting business" in the 1970s).

136. For example, major tax law changes enacted in 1986 created powerful new incentives for taxpayers to avoid the corporate form. *See* Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 874 (1988).

137. Prop. Treas. Reg. § 301.7701-2, 42 Fed. Reg. 1038, 1039 (Jan. 5, 1977).

to ease the pro-partnership bias by abandoning the preponderance test[138] and by doing away with the hyper-technicality that made each of the four factors difficult to satisfy.[139] As a result, corporate classification would have been extended to more unincorporated entities, including those possessing fewer than three of the four factors. The proposed regulations would have reintroduced the tiered structure abandoned by the 1960 regulations by creating a series of examples that provided targeted guidance to supplement the revised four-factor test.[140] However, before taxpayers even had time to express displeasure over the changes,[141] the proposed regulations were withdrawn.[142] The regulations, having apparently fallen victim to a cabinet-level dispute with the Department of Housing and Urban Development,[143] were withdrawn just days after they were published.[144]

The next proposed change came three years later, making no mention of the 1977 proposal.[145] Rather than attempting to reengineer the four-factor test, the proposed regulatory amendments responded narrowly to the emergence of limited liability companies. Under the revised regulation, limited liability companies and any other entities providing for limited liability for all members under local law would have been classified as associations.[146] This change would have effectively pushed the clock back to 1914, taking the same approach to limited liability companies that the 1914 regulations took to limited partnerships.[147] The proposal would otherwise have left the 1960 regulations intact. Three years after the proposal was published, it too was withdrawn.[148]

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138. *Id.* § 301.7701-2(a)(1) ("Because the overall resemblance of an organization to a corporation is determinative for purposes of classification, an organization may be classified as an association when it resembles a corporation with respect to two or more of the four characteristics . . . .").

139. For example, the continuity of life factor in the proposed regulations would be satisfied so long as "members holding a majority of interests . . . have the power to prevent interruption of the business operations of the organization despite a dissolution . . . under local law as a result of a change in the status or identity of one or more members." *Id.* § 301.7701-2(d)(2)(i).

140. *Id.* § 301.7701-2(h).

141. *See* Fisher, *supra* note 90, at 663 (concluding taxpayers would have reacted against the loss of the "vested" benefits of the four-factor test's pro-partnership bias).

142. 42 Fed. Reg. 1489 (Jan. 7, 1977).

143. "[A]fter meeting with officials of HUD and the Service, former Secretary of the Treasury Simon announced that the proposed rules would not be reissued under the Ford Administration." Fisher, *supra* note 90, at 663.

144. 42 Fed. Reg. 1489 (Jan. 7, 1977).

145. Prop. Treas. Reg. § 301.7701-2, 45 Fed. Reg. 75,709 (Nov. 17, 1980).

146. *Id.* § 301.7701-2(a)(2).

147. *See supra* note 79 and accompanying text.

148. 48 Fed. Reg. 14,389-90 (Apr. 4, 1983).

The repeated failures to find a regulatory antidote to the pro-partnership bias of the 1960 regulations paved the way for taxpayers to find new ways to exploit it. The effort to exploit the regulations' bias peaked in the 1980s with the emergence of Master Limited Partnerships.[149] Under the four-factor test, these limited partnerships were classified as partnerships despite having their partnership interests widely held in much the same way as the stock of a public company.[150]

Congress, with the creation of a new statute in 1987,[151] made the anti-association bias of the entity classification regulations significantly less problematic from the government's point of view. It did so by declaring an entity like a Master Limited Partnership to be a "publicly traded partnership"[152] and therefore a corporation for tax purposes, irrespective of the results of the application of the four-factor test. The statute states simply that a publicly traded partnership "shall be treated as a corporation."[153] Under the statute, partnerships whose interests are so freely transferable that those interests are analogous to shares in a public company become corporations for tax purposes.[154]

Limited liability companies, due in part to the existence of the publicly traded partnership rules and also because they offered taxpayers only modest advantages over existing limited partnership-based planning options,[155] had little immediate impact on the tax planning landscape.

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149. By the mid-1980s, the Master Limited Partnership, referred to as an "inside" shelter, proved so popular that companies such as Burger King and International Paper sponsored Master Limited Partnership offerings. *See* Stephen T. Limberg, *Master Limited Partnerships Offer Significant Benefits*, 65 J. TAX'N 84, 84 (1986).

150. In some cases, Master Limited Partnerships had thousands of limited partners. *See* Patrick E. Hobbs, *Entity Classification: The One Hundred-Year Debate*, 44 CATH. U. L. REV. 437, 502 (1995).

151. I.R.C. § 7704 (2000).

152. I.R.C. § 7704(b) defines a publicly traded partnership as a partnership whose interests "are traded on an established securities market" or "are readily tradable on a secondary market (or the substantial equivalent thereof)." *Id.*

153. I.R.C. § 7704(a) (2000).

154. Although formally distinct from the resemblance test, *see supra* notes 75-80 and accompanying text, in terms of the structure of the Internal Revenue Code, the publicly traded partnership rules are themselves a resemblance test. Through the lens of the publicly traded partnership rules, Master Limited Partnerships resemble corporations and are treated like corporations. Effectively, one of the seven *Morrissey* corporate characteristics, free transferability of interests, which in 1960 became one of the four factors used to distinguish corporations from partnerships, *see supra* notes 95-96 and accompanying text, was now a free-standing, one-factor resemblance test.

155.

> The perceived advantage of LLCs as limited liability vehicles diminishes in light of partners' ability to insulate themselves from personal liability by interposing a corporate general partner or wholly owned S corporation. In comparison to a limited partnership, the LLC offers principally the allure of limited liability with a single entity.

Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y

Even as late as 1992, fifteen years after its initial introduction in Wyoming,[156] and four years after the limited liability company was officially recognized as a partnership for tax purposes,[157] limited liability company statutes had been enacted in only eighteen states.[158] Although their potential had generated a great deal of excitement, the use of the limited liability company was not yet widespread.[159]

In spite of its limited real-world impact, the limited liability company played an instrumental role in the creation of the check-the-box election. By focusing "renewed attention" on the partnership classification rules[160] and the obvious shortcomings of the four-factor test, the "hoopla regarding limited liability companies"[161] drew attention to the significant burdens these regulations imposed on taxpayers. Those burdens made the entity classification regime a tempting target for deregulatory reformers. In the mid-1990s, when the public's tolerance for burdensome regulations appeared to reach an historic low,[162] that reform finally arrived. The complex and burdensome 1960 regulations had survived repeated reform efforts targeting their complexity. In the end, what doomed the four-factor test was not so much its complexity as the fact that it imposed significant, and often senseless, burdens on taxpayers.

B. The Check-the-Box Rules

With Notice 95-14, the Clinton administration announced that the effort to recalibrate the resemblance test was over. The Notice proposed replacing the resemblance test with what would come to be known as the check-the-box regulations. In the name of simplification, the check-the-box rules revolutionized the classification of business entities for federal income tax purposes. Although they retained certain aspects of the prior

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13, 23 (1995).

156. The Wyoming legislation was enacted in 1977 at the urging of an oil company and was intended as an improved version of the Panamanian entity called a "*limitada*." Bradley J. Sklar & W. Todd Carlisle, *The Alabama Limited Liability Company Act*, 45 ALA. L. REV. 145, 149-50, 154-56 (1993).

157. *See* Rev. Rul. 88-76, 1988-2 C.B. 360, 360-61. The ruling concluded that limited liability companies should be classified as partnerships with a "fairly straightforward application" of the four-factor test. Brannan, *supra* note 74, at 249, 251.

158. *See* Brannan, *supra* note 74, at 249. However, by September of 1994, forty-six states had adopted limited liability company statutes. *See* Burke, *supra* note 155, at 17.

159. Brannan, *supra* note 74, at 250 ("While tax lawyers can scarcely contain their enthusiasm for this new creature, the actual use of limited liability companies has been fairly limited to date.").

160. *Id.* at 199.

161. *Id.* at 255.

162. *See infra* note 265 and accompanying text.

regulatory regime,[163] they also brought something entirely new to the table. For the first time, the regulations explicitly permitted taxpayer intent, as evidenced by the filing of a short form, to determine how all but a limited number of entities would be classified for tax purposes.

This Section first describes the principal elements of the 1996 regulations. It then enumerates the burdens the new rules sought to eliminate or alleviate as part of their effort to simplify entity classification. Finally, it determines which of those burdens: (i) could fairly be described as complexity; and (ii) would not have been eliminated without the switch from a mandatory to an elective classification system. It concludes that a surprisingly small fraction of the improvement in simplicity produced by the 1996 regulations can be attributed to the creation of the check-the-box election. The bulk of the complexity would not have survived the elimination of the four-factor test.

1. The Issuance of the New Rules

The reaction to the check-the-box rules was distinctly positive. The most common response was "enthusiasm."[164] The change from the resemblance test to the check-the-box rules received "strong support"[165] from the tax bar and was "widely praised as an important, simplifying improvement in the tax law."[166] The new entity classification regulations, unlike the 1977 and 1980 proposals, did not attempt to blunt the pro-partnership orientation of the 1960 regulations. In fact, the check-the-box regulations had little in common with any of the prior classification rules or proposals.

As finalized at the end of 1996,[167] Treasury Regulation section 301.7701-2(b) declared that certain domestic and foreign entities would automatically be classified as corporations. It identified an assortment of

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163. One example is the continued requirement that entities formed under state corporation statutes continue to be classified as corporations for tax purposes. *See* Treas. Reg. § 301.7701-2(b) (1996).

164. George K. Yin, *The Taxation of Private Business Enterprises: Some Policy Questions Stimulated by the "Check-the-Box" Regulations*, 51 SMU L. REV. 125, 125 (1997).

165. Letter from Carolyn Joy Lee, Chair, New York State Bar Association Tax Section to Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, & Margaret M. Richardson, Commissioner, Internal Revenue Service (Aug. 31, 1995), *reprinted in NYSBA Strongly Endorses Check-the-Box Entity Classification Proposal*, TAX NOTES TODAY, Sept. 5, 1995, at 173-74.

166. Yin, *supra* note 164, at 125. Yin expressed some skepticism, suggesting that "such praise is very premature" because "important policy questions need to be resolved before we can accurately gauge the wisdom of the new rule." *Id.*

167. None of the provisions described in this Subsection have been significantly modified since they were introduced in 1996.

entities, including: (i) entities designated "corporations" under state law; (ii) a few other types of domestic entities such as insurance companies and entities wholly owned by a state; and (iii) eighty foreign entities thought to closely resemble domestic corporations. These entities were singled out as "per se"[168] corporations. Entities incorporated under state law, along with the other entities on the per se corporation list, essentially continued to be treated as state law corporations had been since 1909. Under the check-the-box rules all such per se corporations were automatically corporations for federal income tax purposes and could not choose a different classification.

The heart of the check-the-box rules lay in Treasury Regulation section 301.7701-3. That regulation contained two distinct provisions. The first was a new set of rules for classifying entities other than per se corporations, called "eligible" entities. It also contained an authorization for taxpayers to choose a classification other than the default classification for eligible entities.

Treasury Regulation section 301.7701-3(b)(1) specified that in the absence of a contrary election, domestic eligible entities with two or more owners would be classified as partnerships and those with only one owner would simply be disregarded.[169] For foreign eligible entities, the regulations described three possibilities, based on two criteria: limited liability and the number of owners.[170] If no owner had "personal liability for the debts of or claims against the entity by reason of being a member,"[171] an entity was classified as an association and therefore taxable as a corporation. If at least one owner was subject to liability for the entity's obligations, the default rules operated in the same manner as those applicable to domestic entities. Only one owner produced a disregarded entity. More than one owner created a partnership for tax purposes.

Until this point, the check-the-box rules remained relatively conventional. Although they rejected the four-factor test and its invocation of *Morrissey*, the default rules operated along the lines of the resemblance test. This is clear in the regulations' list of foreign per se corporations.[172] Those entities, including France's *Societe Anonyme* and

168. The preamble to the final regulations categorized as "corporations per se" those entities that are classified as corporations and do not have the ability to elect different treatment. T.D. 8697, 1997-1 C.B. 215, 216, § B.

169. The creation of this new tax classification, what has come to be known as a disregarded entity or a tax nothing, was hailed as one of the "major breakthroughs" of the check-the-box regulations. *See* Schler, *supra* note 115, at 1682.

170. Treas. Reg. § 301.7701-3(b)(2)(i) (1999).

171. Treas. Reg. § 301.7701-3(b)(2)(ii) (1999).

172. Treas. Reg. § 301.7701-2(b)(8)(i) (1999).

Germany's *Aktiengesellschaft*, are obviously not organized under a state's corporate laws but are typically large, publicly traded entities with features resembling a U.S. corporation. Applying the four-factor test to a *Societe Anonyme* or an *Aktiengesellschaft* would not have left much doubt that they should be classified as corporations.[173]

Had the 1996 regulations omitted the check-the-box election, they would still have represented a profound transformation and simplification of the rules governing the classification of business entities. The four factors would have been part of tax history. The risk of inadvertent classification as a corporation or partnership, particularly for a domestic entity, would have been a thing of the past. No longer would the tax treatment of a business entity be linked to the sanity of its owners.[174]

The inclusion of the check-the-box election set the check-the-box rules apart from all prior entity classification law. Had the 1996 regulations followed the established pattern, the default rules discussed above would not have been optional, but mandatory.[175] For the first time, taxpayers were authorized to select the tax classification of most entities.[176] By taking advantage of this provision, the owners of an eligible entity could choose a classification other than that resulting from an application of the default rules. For example, a foreign eligible entity with multiple owners, none of whom are liable for the debts of or claims against the entity would be an association under the default rules.[177] By making an election,[178] the owners of the entity could instead decide to cause the entity to be classified as a partnership for U.S. tax purposes.

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173. The regulations specified that these per se corporations were not associations taxable as corporations, but actually corporations. *See* Treas. Reg. § 301.7701-2(a) (1996). Under the pre-1997 classification regime, no foreign entities were corporations but could be associations pursuant to an application of the four-factor test. *See, e.g.*, Rev. Rul. 88-8, 1988-1 CB 403, 404 ("All foreign entities are considered to be 'unincorporated organizations' . . . .").

174. *See* Klein & Zolt, *supra* note 105, at 1012 (noting that under the four-factor test classification could turn on consequences of an owner's insanity).

175. This is not to suggest that taxpayer elections are uncommon in the tax law. *See, e.g.*, I.R.C. § 171(c) (2000) (permitting taxpayers to elect to currently amortize "bond premium"); I.R.C. § 1362(a) (2000) (permitting certain corporations to elect pass-through tax treatment as S corporations). Entity classification had never been explicitly elective.

176. Treas. Reg. § 301.7701-3(a) (1999). Most of the provisions that were enacted in 1996 and became effective at the start of 1997 have not been subsequently modified.

177. Treas. Reg. § 301.7701-3(b)(2)(i) (1999) (treating foreign entities as associations if all members have limited liability).

178. The election is made on the one page I.R.S. Form 8832 and is effective on the date specified on the form (which can be up to seventy-five days prior to the date the election is made or up to one year after the election is made). Treas. Reg. § 301.7701-3(c)(1) (1999).

The treatment that would have resulted under the old four-factor test and any similarities of the entity to a U.S. corporation[179] were irrelevant.

2. Taxpayer Burdens

Between 1960 and 1995, relatively few commentators had kind words for the four-factor test.[180] It was not that little was written about the regulations, but that the attention the regulations attracted was consistently negative.[181] Initially, such criticism drew a distinction between the four-factor test and the pre-1960 resemblance rules. However, as the 1980s drew to a close, critics and reformers began to set their sights on the resemblance test more generally, arguing that the *Morrissey* factors were not merely being misapplied but were themselves problematic.[182] In 1995, their calls for change were answered with the publication of Notice 95-14, announcing the intention of Treasury and the IRS to replace the resemblance test.

This Subsection describes the specific ways in which the change from the four-factor test to the check-the-box rules eliminated or alleviated burdens the entity classification regime had previously imposed on taxpayers. Some, but not all, of the burdens were a product of the pre-1997 entity classification regime's complexity. In almost every case, eliminating those burdens did not require the creation of elective classification rules.

There were five principal ways in which the 1996 regulations eased burdens the previous regulations had imposed on taxpayers: (i) the new regulations employed fewer concepts than the old; (ii) the new regulations permitted taxpayers to achieve greater certainty regarding an

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179. Provided that the entity was not specifically named on the per se list. *See* Treas. Reg. § 301.7701-2(b)(8)(i) (1999).

180. One early exception came in the form of an article written by a practitioner soon after the issuance of the 1960 regulations recognizing that the 1960 regulations, while not intended to be favorable to taxpayers, offered advantages to well-advised taxpayers relative to the pre-1960 regulations. Lyons, *supra* note 134, at 462. The author noted that the 1960 "[r]egulations on associations have set down guide lines much more clearly and in more detail than the old Regulations." *See id.* at 462.

181. Serious criticism of the 1960 regulations by commentators can be found as early as the 1960s. *See, e.g.*, Fisher, *supra* note 90, at 630 ("These regulations—clearly a direct reaction by the Service to its inability to withhold corporate classification from professional service organizations—constitute the very root of the classification problem that remains with us today."); Scallen, *supra* note 70, at 693-94 (objecting to preponderance test). The 1970s saw similar critiques. *See, e.g.*, Fox, *supra* note 82, at 314-15.

182. *See* Rebecca S. Rudnick, *Who Should Pay the Corporate Tax in a Flat Tax World?*, 39 CASE W RES. L. REV. 965, 1050-51 (1989) (dismissing "resemblance test" as perpetuating dated corporate finance concepts); Snoe, *supra* note 73, at 653 (proposing replacement of resemblance test with "paradigm to determine on a principled basis which organizations should be taxable entities and which organizations should be passthrough entities").

entity's classification; (iii) taxpayers seeking pass-through treatment for unincorporated entities enjoyed greater freedom to arrange their business affairs in their desired manner; (iv) the new regulations contained a stronger pro-partnership bias; and (v) taxpayers gained the ability to forgo default treatment by making an election. Of those five, the first three eliminated important sources of complexity, but would have done so even without the check-the-box election. The fourth had no direct impact on the law's complexity. Only the last eliminated complexity by making entity classification elective.

The 1960 regulations embraced nearly all of the corporate characteristics articulated by *Morrissey*.[183] As a result, under those regulations, correctly classifying an entity as either a corporation or a partnership required the evaluation of seven (not four) different factors. As an initial matter, one would need to know whether an entity was incorporated, whether it had "associates" and "an objective to carry on business and divide the gains therefrom"[184] to determine whether the entity constituted a business entity to which the four-factor test would apply. If the answers to those questions were no, yes and yes, respectively, the four-factor test would then determine the classification of the entity in question.[185] If an entity displayed the specified number of factors (either three or four) it would be classified as a corporation and not a partnership. By contrast, under the check-the-box rules, only three relatively straightforward facts[186] are relevant to the classification of a domestic entity: (i) whether the entity is incorporated;[187] (ii) whether it is engaged in a business;[188] and (iii) the number of owners it has.[189] The reduction in the number of questions to be answered by a taxpayer seeking to classify an entity provided a clear benefit to taxpayers.

At least with respect to the classification of domestic entities, not one of the four factors survived the transition from the 1960 regulations

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183. The 1960 regulations only omitted the "centralization of title" characteristic. *See* Morrissey v. Comm'r, 296 U.S. 344, at 359 (1935) ("A corporation, as an entity, holds title to the property embarked in the corporate undertaking.").

184. Treas. Reg. § 301.7701-2(a)(1) (1960).

185. *See id.* § 301.7701-2(a)(2).

186. It is important to note that these facts bear little resemblance to the four factors. After 1960, applying each factor required the evaluation of a number of discrete facts. How many owners an entity has, for example, is usually a straightforward question of fact. *But see, e.g.*, I.R.S. Priv. Ltr. Rul. 199911033 (Dec. 18, 1998) (treating limited liability company with two members as single-member entity). Determining whether an entity had continuity of life, as defined by the 1960 regulations, required an extensive inquiry into the often purely technical details of an entity's design. *See supra* note 104 and accompanying text.

187. Treas. Reg. § 301.7701-2(b)(1) (1999).

188. *Id.* § 301.7701-1(a)(2).

189. *Id.* § 301.7701-3.

to the 1996 regulations. Under the default rules, determining the proper classification of a domestic entity still requires knowledge of three items of information about the entity, but the four factors are simply no longer relevant. An entity incorporated under the laws of a state is still always taxed as a corporation, an objective to carry on business helps distinguish associations and partnerships from other entities or arrangements,[190] and whether an entity has a single owner or multiple owners can be crucial in determining whether an entity will be classified as a partnership. Knowing these three factors marks the end, not the beginning, of the classification inquiry. One of the four factors, limited liability, remains potentially relevant to the classification of foreign entities.[191]

The benefit taxpayers derived from the elimination of the four-factor test is more significant than the reduction in the number of potentially relevant considerations from seven to three would suggest.[192] Even thirty years after their introduction, achieving certainty in the application of even one of the four factors to real-world situations remained difficult.[193] Taxpayers "frequently" found themselves facing issues that had "not been definitively resolved" by existing administrative guidance.[194] Because the pains the creators of the 1960 regulations took to make the four factors difficult to satisfy were responsible for much of the 1960 regulations' rule complexity,[195] doing away with the four factors eliminated a disproportionate amount of complexity. Although the three remaining considerations have not always proven as mechanical as one might expect,[196] even if the default rules had been made mandatory they would not have produced the same type of open-ended inquiries that plagued the four-factor test.

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190. Treas. Reg. § 301.7701-1(a)(2) provides that certain joint ventures lacking a business purpose will not create an entity for tax purposes. In addition, Treas. Reg. § 301.7701-4(b) provides that an entity "technically cast in the trust form" will be classified pursuant to the business entity classification rules if it is merely a "device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships."

191. Treas. Reg. § 301.7701-3(b)(2)(i)(B) (1999). The definitions of limited liability provided in the two sets of regulations differ in important respects. *Compare* Treas. Reg. § 301.7701-3(b)(2)(ii), *with* Treas. Reg. § 301.7701-2(d) (1999). One important difference between the two definitions is that the 1996 regulations omit the "dummy" element that had been a troublesome part of the prior rules. *See* Brannan, *supra* note 74, at 212-14.

192. In the non-U.S. context, the change would have been from seven to four, including the modified limited liability concept.

193. *See generally* Brannan, *supra* note 74 (cataloguing numerous unresolved issues relating to the four factors).

194. NYSBA 1995, *supra* note 69, at Part III.A.

195. *See supra* notes 101-05 and accompanying text.

196. *See, e.g.*, *supra* note 186 and accompanying text.

There is a third way in which the elimination of the four-factor test improved the state of affairs from the taxpayer's perspective. Under the 1960 regulations, taxpayers were provided with a test for determining the classification of an unincorporated entity that made it possible for taxpayers to avoid the application of the corporate tax. Within limits, and often at significant cost, lawyers drafting the organizational documents for such an entity could effectively choose to treat it as a partnership.[197] By allowing taxpayers seeking partnership treatment for an unincorporated entity greater freedom to structure their business relationships without an eye on the four factors, the check-the-box regulations eliminated an important cost of doing business for taxpayers.

These first three benefits responded directly to taxpayer concerns regarding the complexity of the 1960 regulations.[198] That was not true of the fourth benefit taxpayers derived from the check-the-box regulations. Under the 1996 regulations, for non-publicly traded entities, the four-factor test's pro-partnership bias not only survived, it actually became more pronounced. This was an advantage to taxpayers not because it made a result previously possible simpler and less costly to achieve, but because it permitted taxpayers to do something entirely new. The 1996 regulations permit virtually every domestic entity that would have been required to be classified as either an association or a partnership under the four-factor test to be classified as a partnership.[199] Foreign eligible entities, a category that includes all but a limited number of non-public[200] foreign entities, possessing as many as three of the four factors, automatically qualify as partnerships under the default rules. The default provisions of the check-the-box rules extended partnership treatment well beyond the line created by the 1960 regulations.

It is important to recognize that not one of the improvements discussed so far relies on the signature feature of the check-the-box

197. *See* Weisbach, *supra* note 126, at 1629.

198. They increased rule simplicity by making the classification rules easier to understand and apply. Transactional simplicity improved significantly because taxpayers no longer needed to modify their business arrangements to qualify for partnership tax treatment under the check-the-box rules. Abandoning the four-factor test also reduced compliance complexity by sparing taxpayers from the necessity of monitoring an entity's ongoing compliance with the test's many requirements. Remarkably, the per se rules and the default classification rules for eligible entities even avoided creating new concepts that might create ambiguities or problems. The notable exception to that display of restraint was the creation of the tax nothing. *See supra* note 169 and accompanying text.

199. The check-the-box rules eliminated the possibility that entities with one owner could be partnerships for tax purposes. *See* Brannan, *supra* note 74, at 255-57. Under the revised rules, a single-member entity not treated as a corporation is disregarded as an entity for tax purposes. Treas. Reg. § 301.7701-3(b)(1)(ii) (1999).

200. The publicly traded partnership rules prevent a publicly traded foreign eligible entity from achieving partnership tax treatment.

regulations. They are all a product of the elimination of the four-factor test. Even had the regulations not allowed taxpayers to affirmatively select a classification for an entity, the revised classification rules would still have freed domestic entities from the burdens imposed by the four factors and the preponderance test. Foreign eligible entities would have been subject to a more generous one-factor test turning solely on limited liability. Entity classification would still have been far less burdensome for taxpayers if the default rules of the 1996 regulations had been mandatory rules.

The final benefit taxpayers derived from the 1996 regulations was the ability to forgo default classification by making a check-the-box election. This was helpful to taxpayers in two ways. It gave them the ability to make prophylactic elections and the ability to choose and change classifications. The concept of a prophylactic election refers to taxpayers' ability to elect the same classification for an eligible entity that the default rules would produce. Such an election permitted taxpayers to circumvent the application of even the streamlined resemblance criteria retained by the 1996 regulations. For example, the owners of a foreign eligible entity that are only 51% certain that none of them has "personal liability for the debts of or claims against the entity" are able to avoid the effort and expense necessary to definitively establish the presence or absence of limited liability by filing a one-page form.[201]

In the cross-border setting, the ability to avoid requiring United States tax counsel to collaborate with foreign corporate counsel to conduct an analysis of local law can be a significant advantage.[202] By contrast, given the simplicity of the default classification rule for domestic entities, it is difficult to imagine circumstances in which a domestic prophylactic election would be made. In effect, the benefits of prophylactic elections apply only with respect to the classification of foreign eligible entities. Had the 1996 rules only applied to domestic

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201. Treas. Reg. § 301.7701-3(b)(ii) (1999). It may seem surprising that the owners of an entity would not know whether they might have liability for its debts. However, the risk associated with owner liability might be slight for an entity with little debt operating in a relatively non-litigious jurisdiction. Alternatively, an entity could be a lower-tier entity, such that intervening entities between the ultimate owners and the eligible entity would suffice to prevent those owners from being exposed to potential liability. Taxpayers may also find it difficult to determine whether an entity acting as general partner with unlimited liability but very limited assets will be respected as a partner.

202. NYSBA 1995, *supra* note 69, at Part V.B.1 (noting the difficulty United States tax lawyers faced under prior law in collaborating with foreign counsel to apply resemblance criteria to foreign entities).

entities,[203] prophylactic elections would not have provided any meaningful benefit to taxpayers.

The election also permitted taxpayers to achieve results that would have been costly to produce without an election. Taxpayers like Dr. Kintner, whose circumstances made corporate treatment preferable to the default pass-through treatment but who were unable to incorporate, could achieve their objectives by making an election. Similarly, a taxpayer wishing to change the classification of an entity could simply elect a new classification.[204] As Notice 95-14 observed, sufficiently motivated taxpayers could generally achieve the same result as having a non-corporate entity reclassified as a corporation without an election by forming a new corporation, having the partnership contribute its assets to that corporation then liquidating the partnership.[205] The "virtual" transaction[206] made possible by the check-the-box election is clearly less burdensome than a self-help conversion.[207]

It is indisputable that the addition of the check-the-box election eliminated burdens imposed on taxpayers. Permitting prophylactic elections spared taxpayers from even the modest complexities of the default rules for classifying foreign eligible entities. Allowing virtual conversions enabled taxpayers to achieve tax objectives that frictions[208] would otherwise have made costly. By doing so, the check-the-box election eliminated significant sources of both rule and transactional complexity from the tax law. Nevertheless, it is remarkable to observe that of the five principal taxpayer benefits, only one eliminated complexity that would have survived had entity classification not been made elective.

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203. Notice 95-14 suggested this was a real possibility. *See supra* note 13 and accompanying text.

204. The regulations limit the frequency of permissible classification changes. Treas. Reg. § 301.7701-3(c)(iv) (1999). For a period of sixty months following the filing of a classification election other than an initial classification election no further elections are permitted. *See id.*

205. *See* Notice 95-14, *supra* note 9, at 298.

206. Check-the-box elections also permit taxpayers to add virtual steps to real transactions. Those virtual steps can result in significantly more favorable tax treatment for certain transactions. The "check-and-sell" transactions targeted by the failed "extraordinary transaction" regulations illustrate the impact of such virtual steps. Prop. Treas. Reg. § 301.7701-3(h)(1), 64 Fed. Reg. 66,591, 66,594 (Nov. 29, 1999), *withdrawn*, I.R.S. Notice 2003-46, 2003-28 I.R.B. 53.

207. In addition to obviating the need to actually form or liquidate entities, the virtual transaction offers the added benefit of averting any risk that the contractual rights and obligations of the existing entity might not legally be transferable to the newly formed entity. *See, e.g.*, NYSBA TAX SECTION, REPORT ON THE PROPOSED "CHECK THE BOX" REGULATIONS ¶ 26, *reprinted in, NYSBA Submits Report of Check-the-Box Regs.*, TAX NOTES TODAY, Aug. 28, 1996 [hereinafter NYSBA 1996] (noting costs and risks of an "actual conversion transaction").

208. *See infra* note 251 and accompanying text.

3. Government Burdens

For all the benefits the check-the-box rules afforded taxpayers, Notice 95-14's proposal was intended to ease burdens on both taxpayers and the government. Doing away with the four-factor test, the Notice explains, represented a benefit to the government as well. The Notice observes that both "[t]axpayers and the Service . . . continue[d] to expend considerable resources" complying with and enforcing, respectively, the four-factor test.[209] As a result, eliminating the four-factor test reduced the level of both public and private resources devoted to entity classification. The Notice sets out a proposal to eliminate obsolete rules based on outmoded concepts[210] for which the government had no more appetite than did taxpayers. It emphasizes the administrative costs of providing guidance to taxpayers regarding the four-factor test[211] and concludes that eliminating the four-factor test would serve the cause of simplification by eliminating those costs.

The government's willingness to abandon the resemblance test was in part due to the existence of the publicly traded partnership rules. After regulations that would have rolled back the 1960 regulations' pro-partnership bias were repeatedly withdrawn, the publicly traded partnership rules succeeded in doing exactly that for some entities.[212] Those rules essentially added a limited redundancy to the entity classification regime. It added a second set of resemblance rules with several advantages over the four-factor test.

First, Congress created the publicly traded partnership rules by crafting a new statute. As a result, the survival of the resemblance concept was no longer linked to the fate of Treasury Regulation section 301.7701-3.[213] In addition, by exporting resemblance principles to a new

209. Notice 95-14, *supra* note 9, at 297.

210. "The existing classification regulations are based on the historical differences under local law between partnerships and corporations." *Id*.

211. "[S]ince the issuance of Rev. Rul. 88-76, the Service has issued seventeen revenue rulings analyzing individual state limited liability company statutes, and has issued several revenue procedures and numerous letter rulings relating to classification of various unincorporated organizations under the classification regulations." *Id.*

212. In a limited sense, the publicly traded partnership rules mirror the 1977 proposed regulations. *See* Fox, *supra* note 82, at 332 (finding early case law relied on free transferability principally as evidence of continuity of life, a separate factor under the four-factor test factor). Fox sees free transferability as a sort of two-for-one factor, as its presence indicates the existence of continuity of life, a second factor. Treating public trading as the ultimate form of free transferability, the publicly traded partnership rules treat an unincorporated entity as a corporation even though the entity displays only two (or one factor counted twice) of the four factors. Eliminating the preponderance test while retaining the resemblance test, so that an entity displaying only two of the four factors could be classified as an association, was at the core of the 1977 proposal.

213. Commentators have noted that, in substance if not in form, the resemblance test survived

section of the Code, the publicly traded partnership rules gave resemblance a fresh start. Enacted in response to very public tax shelter activity, the publicly traded partnership rules could lay claim to a legitimacy[214] that the four-factor test could not.[215]

The elimination of the four-factor test greatly reduced the costs of explaining and enforcing the distinction between corporations and partnerships. Although the publicly traded partnership rules offer interpretive challenges,[216] they are a far cry from the self-constructed maze[217] of the four-factor test.[218]

The creation of the check-the-box election, by contrast, did not eliminate any of the government's burdens. Processing and acknowledging check-the-box elections places significant demands on government resources, yet provides no clear advantages[219] and no possibility of increased revenue[220] over a world with no check-the-box election. The taxpayer's option to file an initial election contemporaneously with the formation of an entity[221] may provide the IRS with timely information regarding taxpayer deviations from the default rules,[222] but in the absence of the election, there would be no

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the repeal of the four-factor test in favor of the check-the-box rules because of the existence of the publicly traded partnership rules. *See* Polsky, *supra* note 84, at 227. Although the check-the-box rules explicitly rejected the resemblance concept, because they did so with knowledge that the publicly traded partnership rules would apply to treat certain unincorporated entities resembling corporations as corporations for tax purposes, they were viewed as embracing resemblance principles. "Check-the-Box classification's practical emphasis on public trading is consistent with the historical application of the resemblance test and with recent congressional legislation. It is a reasonable implementation of the congressional mandate to impose the corporate tax on entities that substantively resemble corporations." Fleischer, *supra* note 111, at 549.

214. "Using public trading as a proxy for corporate resemblance is not just reasonable, but a wise policy decision as well." *Id*.

215. *See, e.g.*, Klein & Zolt, *supra* note 105, at 1010 ("How successful is the [four-factor test] in classifying entities for tax purposes? Not very. We believe that any tax test that seeks to distinguish between entities based on nontax characteristics, without regard for tax objectives, will be arbitrary.").

216. Whether interests in unincorporated entities are "readily tradable" on a "secondary market," for example, is not as obvious as whether its ownership interests are traded on the New York Stock Exchange. *See* Treas. Reg. § 1.7704-1(c) (2005).

217. Fox, *supra* note 82, at 362.

218. Moreover, because the publicly traded partnership rules rely on information that is, by its nature, to some degree publicly available, they made the job of identifying entities misclassified as partnerships less difficult.

219. Taxpayers are able to avoid the new "one-factor test" applicable to foreign eligible entities by making a check-the-box election. However, not every taxpayer with the option of making an election will do so. As a result, the government still needs to devote resources to explaining and enforcing the test.

220. Yin, *supra* note 164, at 130 ("If the taxpayer is well-advised, the [check-the-box] election, which has ramifications for tax purposes only, will always be to the detriment of the fisc.").

221. *See supra* note 178.

222. In the absence of a contemporaneous filing requirement, taxpayers could delay revealing

such deviations. The possibility that taxpayers will provide the government with information regarding their activities and the limitations imposed on taxpayers' ability to make elections,[223] can be thought of as benefiting the government by curtailing taxpayers' ability to engage in tax planning. However, those limitations put the government in no better position than it would have been in if neither the four-factor test nor the check-the-box election existed.

4. What Sources of Complexity Did Electivity Eliminate?

Judging the impact of the check-the-box election on the complexity of the tax law first requires acknowledging that the 1996 regulations actually did two things rather than one. The changes not only eliminated the four-factor test but also introduced a new and different type of classification regime. Eliminating the four-factor test resulted in a significant reduction in transactional, rule, and compliance complexity. The contribution of the regulations' innovative[224] elective system to tax simplification was more modest: the prophylactic election and explicit classification choice.

The prophylactic election offered taxpayers a cure for vestiges of the four-factor test's complexity that survived the 1996 changes. Because the default classification of a foreign eligible entity turns on whether its owners enjoy limited liability,[225] without the election taxpayers could find themselves in a situation reminiscent of the pre-1997 regime. Although only required to wrestle with one factor rather than four, the challenge of understanding how the revised U.S. tax law concept of limited liability applied to a particular foreign entity could be significant. The election permitted taxpayers to circumvent the application of the default rules along with the rule, transactional, and compliance complexity that might accompany understanding and conforming to those rules. As a result, taxpayers that would find it costly to apply the concept of limited liability were not compelled to do so.

The other change that can be attributed to the creation of the check-the-box election is the ability to more easily choose a nonstandard classification. Obviously, even without an explicit election, taxpayers

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their classification intentions until an entity first had to file a tax form that required a declaration of classification, such as I.R.S. Form SS-4, which is required for an entity to be assigned an Employer Identification Number.

223. The most important limitation is the prohibition on multiple classification changes within a five year period. *See supra* note 204.

224. *See supra* note 69.

225. The 1996 version of this factor is similar, but not identical to, the 1960 version. For example, it lacked the component requiring a determination regarding the "dumminess" of the general partner. *See supra* note 191 and accompanying text.

would have been able to make an effective initial election by choosing between per se or eligible entities.[226] The purpose of the explicit election was to make classification choice less complex "to reduce the burdens on both taxpayers and the Service"[227] and not merely, as a recent opinion suggests, to create "a more formal version of the informally elective regime under the *Kintner* regulations."[228]

By permitting taxpayers to choose, for instance, to treat a limited liability company as a corporation, as an alternative to the standard partnership treatment, the election spares taxpayers from whatever transactional complexity would result from using a corporation when a limited liability company would be superior for non-tax reasons. In addition, because the election permits classification changes as well as the selection of an initial classification, the election enables taxpayers to avoid the costly[229] process of making a self-help classification change.[230] That savings is also attributable to a reduction in transactional complexity.

Despite the fact that Notice 95-14 emphasized from the start that the change from the four-factor test to the check-the-box rules was intended to "simplify the rules,"[231] the existence of the check-the-box election has puzzled commentators from almost the moment it was introduced[232] and continues to invite speculation as to what motivated its creation.[233] This is true although there is little mystery as to why the

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226. That would have mirrored the ability of taxpayers under prior law to "effectively elect" corporate or partnership treatment by choosing a corporation or crafting a limited partnership or other unincorporated entity to fail the four-factor test. *See* NYSBA 1995, *supra* note 69, at Part III.B.

227. Notice 95-14, *supra* note 9, at 298.

228. Littriello v. United States, No. 04CV-143-H, 2005 U.S. Dist. LEXIS 9813, at *9 (W.D. Ky. May 18, 2005).

229. Given that some states now permit taxpayers to "convert" entities from one form to another, for example changing a limited liability company to a corporation, as a matter of state law, it may be that the cost of an actual conversion is lower than it would have been when the check-the-box regulations were enacted. *See, e.g.*, Gary W. Derrick & Irving L. Faught, *New Developments in Oklahoma Business Entity Law*, 56 OKLA. L. REV. 259, 267 n.44 (2003) (noting that Oklahoma introduced conversion provisions modeled after Delaware statutes).

230. Taxpayers could "elect" a new classification for an entity by forming a new entity with a different classification and transferring business assets from the old entity to the new via merger or contribution. *See* NYSBA 1995, *supra* note 69, at Part IV.B.2.

231. Notice 95-14, *supra* note 9, at 298.

232.

> [T]here remains the question of why certain business firms should be entitled to *choose* the set of rules controlling how their income is taxed. In general, the tax system does not permit taxpayers to elect the rules applicable to them . . . It is unclear why the check-the-box regulations should deviate from this usual approach.

Yin, *supra* note 164, at 130.

233. *See* Polsky, *supra* note 84, at 238-39, 243 (concluding the check-the-box election was

four-factor test was eliminated. The elimination of the four-factor test took with it the enormous amount of complexity the 1960 regulations had produced. While the 1996 regulations were created in the name of simplification, simplification does not adequately explain the existence of the check-the-box election. By comparison with the elimination of the four-factor test, the check-the-box election was responsible for a relatively modest reduction in the tax law's complexity. At the same time, as discussed below, it injected significant new complexity into the tax law.

IV. TAX SIMPLIFICATION OR TAX DEREGULATION?

One interesting question to ask about the check-the-box election is whether it simplified the tax law. A more important question is why its creators were confident that it would.[234] The creation of the explicit election was intended to permit taxpayers to achieve the same ends permitted under prior law, effective classification choice[235] and self-help classification changes, at less cost. Without doubt, the check-the-box election enabled taxpayers to eliminate some costs associated with choosing and changing classifications.

Still, genuine tax simplification is not just a matter of eliminating existing sources of complexity, which the election did, but of eliminating more complexity than the change itself creates. The passive loss rules, for example, eliminated significant amounts of transactional complexity, but should only be called a simplifying change if they created less complexity than they eliminated. Given that the check-the-box election unleashed a substantial amount of complexity, at least some of which was apparent when the regulations were finalized,[236] it is difficult to

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designed to avoid any possibility of taxpayer constitutional challenges of the abandonment of the *Morrissey* factors). A recent taxpayer challenge to the validity of the check-the-box regulations on the grounds that they represented an unconstitutional exercise of regulatory authority failed. *See Littriello*, 2005 U.S. Dist. LEXIS 9813.

234. This discounts the possibility that they believed the check-the-box election would make the tax law more complex. One could speculate that a complex provision was intentionally created under a pretext of simplification. Possible reasons for doing so include regulatory capture or as some sort of inducement for taxpayers to accept changes to the four-factor test when two earlier attempts to change the four-factor test had failed. Even if such an ulterior motive were behind the creation of the election, it seems unlikely that its designers would consciously choose to use a rule that they recognized as complex to achieve their ends. Moreover, because the default rules strengthened rather than weakened taxpayers' ability to achieve partnership tax classification for near-corporate entities, the 1996 regulations would almost certainly have received a much warmer reception than the 1977 or 1980 proposals even without the election.

235. *See supra* note 226 and accompanying text.

236. *See* Reuven S. Avi-Yonah, *To End Deferral as We Know It: Simplification Potential of Check-the-Box*, 74 TAX NOTES 219, 219-20 (1997) (describing widespread doctrinal implications of

understand how the check-the-box election could have been viewed as a simplification measure.

This Part first describes the ways in which the check-the-box election made the tax law more complex and then suggests an explanation for the (unjustified) confidence that it would simplify. It concludes that the check-the-box election was perceived to be a simplification measure because the election, although complex, was advantageous for and attractive to taxpayers. Simplification was presented expressly as a means of deregulating by reducing taxpayer and government burdens.[237]

Because the existence of the check-the-box election economically benefited rather than burdened taxpayers, it did not conflict with the deregulatory policy goals of the 1996 regulations. Conflating tax complexity and taxpayer burdens, the creators of the check-the-box election treated the attractive complexity generated by the election as benign. Discounting that attractive complexity made the election appear to be a simplification measure even though it did not unambiguously reduce the amount of resources devoted to the tax law.

A. The Rise in Complexity Produced by the Check-the-Box Election

Taxpayers responded to the creation of the check-the-box election with enthusiasm.[238] If taxpayers responded positively to the check-the-box election, but disliked complexity, how could it have been complex? As described in Part II, although a complex rule may be pro-taxpayer,[239] it is still complex. Complexity, and the wasted resources and other harms it produces, is independent of taxpayer preference.[240]

Elections of all kinds are "inherently costly and complex for the taxpayer."[241] The check-the-box election is no exception. Elections are

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check-the-box elections for United States international tax law).

237. "[T]he purpose of this approach is to simplify the rules in order to reduce the burdens of both taxpayers and the Service." Notice 95-14, *supra* note 9, at 298.

238. *See* Yin, *supra* note 164, at 125 n.2.

239. Describing a rule as pro-taxpayer is not meant to suggest that it is necessarily regressive. The EITC, for example, is both pro-taxpayer and progressive. *See supra* note 44 and accompanying text.

240. Taxpayers may view themselves as better off under a simple rule than under a more complex rule. However, that will not be true in every case. Cost savings attributable to greater simplicity may be no match for the loss of related benefits. For that reason, taxpayers have no reason to view all forms of complexity as burdensome. A rational taxpayer should be willing to bear, at least in some cases, the costs of understanding a complex statute even if those costs are significant. That should be true so long as those costs are even a dollar less than the tax or other benefits that rule will generate as compared to an alternative rule with a plain meaning.

241. Yin, *supra* note 164, at 130.

complex and costly because they offer taxpayers a choice.[242] They require taxpayers to both understand the tax implications of choosing one path over another and to predict which will be a better choice based on their anticipated future circumstances. By offering taxpayers a new kind of choice, the elections made entity classification more important and made it more complex.

The extent of the complexity created by the introduction of the check-the-box election was unusual. In particular, the amount of rule complexity resulting from the interplay among the check-the-box election and the many tax rules affected by an entity's classification or change in classification is not typical of tax elections.[243] A relatively straightforward illustration of the rule complexity[244] generated by the election is that the election permitted taxpayers to achieve results, such as turning a corporation into a partnership, that mimicked a variety of transactions.[245] Because the tax consequences of those transactions could vary significantly, there was no obvious way to determine the consequences of a classification change. Until regulations were issued that resolved the matter,[246] taxpayers were saddled with significant

242. "The taxpayer must incur the transaction cost of evaluating all tax consequences of the available options before making an informed choice." *Id.*

243. The doctrinal ripples from most elections simply do not travel as far as those generated by a check-the-box election. Tax elections typically have relatively few implications beyond a specific area of the tax law. An example of the usually narrow impact of tax elections is offered by I.R.C. § 171(c). That provision permits taxpayers to choose to amortize a bond premium currently, affecting only the timing of the taxpayer's recovery of that premium. However, other elections, like the I.R.C. § 1362 election to treat a corporation as an S corporation, have a much broader impact.

244. The check-the-box regulations may generate less rule complexity than the four-factor test, but the difference is not as great as one might expect. One unscientific measure is a search of the Lexis database that includes the Cumulative Bulletin and Internal Revenue Bulletin as well as Private Letter Rulings and Technical Advice Memoranda. For the five years ending on December 31, 1996 a search of "'301.7701-2' or '301.7701-3'" returns 702 documents. LEXISNEXIS, IRS Cumulative Bulletin, IRB, Letter Rulings, & Technical Advice Memos Database (last searched Feb. 1, 2006), *available at* LEXISNEXIS:IRS Cumulative Bulletin, IRB, Letter Rulings, & Technical Advice Memo/search: "301.7701-2 or 301.7701-3" and date(geq (12/31/1992) and leq (12/31/1997)). The same search for the five years starting January 1, 1997 produces 609 documents. LEXISNEXIS, IRS Cumulative Bulletin, IRB, Letter Rulings, & Technical Advice Memos Database (last searched Feb. 1, 2006), *available at* LEXISNEXIS:IRS Cumulative Bulletin, IRB, Letter Rulings, & Technical Advice Memo/search: "301.7701-2 or 301.7701-3" and date(geq (1/1/1997) and leq (1/1/2002)). Much of the rule complexity of the check-the-box regulations can be traced to the impact of the election.

245. The contribution of corporate assets to a newly formed partnership followed by a corporate liquidation or alternatively a liquidation followed by a contribution of the assets to a newly formed partnership by the former shareholders of the corporation can produce different tax results; taxpayers relying on elections to produce a virtual conversion would be required to determine which treatment applied.

246. Treas. Reg. § 301.7701-3(g) (2005).

uncertainty.[247]

Fully cataloguing the questions[248] prompted by the introduction of the election (especially the realistic possibility of mid-stream classification changes) is difficult in part because of the centrality of the distinction between corporations and partnerships in the tax law.[249] The income tax is not complex, in the sense of being difficult to understand, just because it consists of a large number of individual provisions or because each individual provision is difficult to understand. Its rule complexity also derives from the fact that so many of its provisions are interrelated. The combination of this intricacy and the fact that the corporation/partnership distinction is close to the center of the spider's web that is the income tax makes it impossible to trace all of the questions[250] raised[251] by the creation of the check-the-box election.[252]

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247. Interestingly, the burden imposed on taxpayers by requiring them to determine the tax consequences of classification changes was explicitly acknowledged when the regulations were finalized, but that burden was not specifically identified as a product of rule complexity and was deemed "outside the scope of these classification rules . . . ." T.D. 8697, 1997-1 C.B. 215, 219. The uncertainty was addressed by subsequently issued regulations. *See* Treas. Reg. § 301.7701-3(g) (2005). "By finalizing the check-the-box conversion Regulations, the IRS has provided a measure of certainty to increasingly common factual situations." Roger F. Pillow & John J. Rooney, *Check-the-Box: Final Conversion Regs. Add Clarification While New Prop. Regs. Add Some Uncertainty*, 92 J. TAX'N 197, 206 (2000).

248. See Avi-Yonah, *supra* note 236, for an early "partial" list of situations in which the availability of check-the-box elections could affect international tax planning. By changing the landscape in which the rules Avi-Yonah mentions—such as the foreign tax credit and the cross-border tax-free reorganization provisions—function, the creation of the check-the-box election forced taxpayers to rethink questions once considered settled and to confront issues that had previously been of little importance. In doing so, taxpayers would need to take into account an additional variable: the ability to change classifications. *See id.*

249. Robert Charles Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 97-100 (1977) (identifying the 1909 decision to impose a tax on corporations but not partnerships as the first of seven basic decisions from which modern corporate tax law evolved, what he calls the "separate tax principle").

250. To get a sense of how the check-the-box election made entity classification a more complex proposition, imagine the owners of a fledgling business attempting to decide what type of entity would best suit their needs. Under the check-the-box rules, they first need to choose an entity that would give them their desired tax treatment and liability protection. They also need to consider the possibility that a classification change might be helpful in the future. If they desired corporate tax treatment and were confident that that would remain true, should they nevertheless form a limited liability company and choose to have it treated as a corporation? They might choose to do just that to leave themselves the flexibility to address future contingencies. For example, they might find that in the context of a future winding up or sale of the business that a deemed liquidation could be advantageous.

251. Of course, not all of the questions were really new. Some may have simply never been squarely confronted because, as a practical matter, they would rarely come up. For example, there is no reason why an adequately motivated taxpayer could not have changed the classification of an entity under the 1960 regulations by changing how many of the four factors it exhibited. However, it would undoubtedly have been difficult to do so. The transactional complexity costs that would have inhibited such a self-help election acted as "frictions" that prevented taxpayers from engaging

The "dazzling"[253] number of tax planning opportunities created by the interaction of the check-the-box election with existing rules evidences the widespread impact of the election on the tax law.[254]

Despite its initial reluctance,[255] Treasury made check-the-box elections available to both domestic and foreign entities. Although it was not obvious that it would be so at the time the regulations were finalized in 1996, the international impact of the check-the-box election has eclipsed its domestic significance. Relative to the more modest advances in both simplicity[256] and complexity that the check-the-box election produced by making domestic entity classification elective, in making the classification of foreign entities elective, the check-the-box regulations changed the international tax landscape in broad strokes. If the 1999 conversion amendments illustrate the added complexity the election created on the domestic front, its international equivalent would clearly be the extraordinary transaction amendments to the entity classification regulations. Proposed in 1999 and withdrawn in 2003[257] in the face of heavy criticism, those amendments took aim at the intersection of the check-the-box elections and the famously complex Subpart F rules.

The extraordinary transaction amendments were designed to prevent transactions that were characterized as abuses of the check-the-box regulations. More broadly, the amendments can be understood as a response to complexities arising from the collision of the check-the-box election and the Subpart F rules. The transactions that the amendments targeted relied on taxpayers' new ability to change the classification of a

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in behaviors that, while theoretically possible, would have been prohibitively expensive. *See* David Schizer, *Frictions as a Constraint on Tax Planning*, 101 COLUM. L. REV. 1312, 1315 (2001) (identifying "frictions" as an important factor constraining taxpayer behavior in ways that make some tax rules more effective than others). In an important sense, these frictions kept the tax law simpler by preventing taxpayers from facing costly uncertainties. In addition to the frictions that could be thought of as complexity costs, the foreign tax consequences of self-help classification changes acted as an important constraint on the ability of taxpayers to change the classification of an entity without the benefit of check-the-box elections.

252. Clark's analysis illustrates how extensive the doctrinal impact of changes in the basic building blocks of the income tax can be. Clark, *supra* note 249, at 97-100. Because it directly implicates the first of Clark's seven principles, the "separate tax" principle, his model suggests that a change to the entity classification regime will tend to have widespread doctrinal consequences. *See id.*

253. Walser & Culbertson, *supra* note 22 at 405.

254. "[A] practical approach to check-the-box planning may initially be frustrated by the bewildering variety of schemes on offer, ideas that bounce around the tax code like a pinball machine, setting off colored lights and bells." *Id*.

255. *See supra* note 62 and accompanying text.

256. Domestically, only the ability to change classifications simplified. A prophylactic election serves no purpose with respect to a domestic entity. *See supra* note 203 and accompanying text.

257. *See supra* note 206.

foreign eligible entity shortly before a sale of that entity.

Because the Subpart F rules were created in a pre-check-the-box world, they were structured in a way that treated corporate status as an immutable entity trait. Although only frictions[258] prevented taxpayers from escaping corporate status through self-help classification elections, in the absence of those frictions taxpayers were able to employ transaction structures that significantly reduced the amount of tax imposed pursuant to Subpart F. With the creation of check-the-box elections, entity classification became an additional, and critical, variable in the Subpart F equation. However difficult it had been to understand all of the implications of Subpart F before the issuance of the 1996 regulations, that new variable produced even greater complexity.

The rule complexity described above is clearly significant. One way to gauge the cost of that complexity in terms of societal resources would be to quantify expenditures by taxpayers seeking to capitalize on the tax-planning opportunities created by the existence of the check-the-box election. There is little reason to believe that that figure would be small.[259] If the figure, along with the costs of the transactional and compliance complexity produced by the existence of the election,[260] is larger than the resources saved by permitting prophylactic elections and explicit classification choice, then the check-the-box election would have made the tax law more complicated rather than less.

B. Tax Deregulation: Making the Tax Law Less Burdensome

Irrespective of whether the move from the mandatory system created in 1960 to the new elective classification system in fact decreased the tax law's complexity, it is clear that the check-the-box election was neither essential to the important increase in simplicity that accompanied the elimination of the four-factor test nor definitively simplifying in its own right. The historical context in which the check-the-box regulations were created, as described below, and the contemporaneous statements of its creators and commentators offer an

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258. These frictions included potentially significant foreign tax consequences.

259. *See, e.g.*, *supra* note 254. One could also compare IRS efforts to offer guidance to taxpayers under the undeniably complex four-factor test and, after the elimination of the four-factor test, under the check-the-box regime. *See supra* note 244.

260. Examples of that compliance complexity include the task of filing the actual check-the-box elections and the necessity of keeping track of the tax classifications of eligible entities. The check-the-box election also encourages taxpayers to use eligible entities such as limited liability companies rather than per se entities, even if a per se entity would be preferable for non-tax reasons. This is because an eligible entity that has made an election to be taxed as a corporation can later change its classification if necessary, while a per se corporation could not. The costs of choosing a suboptimal entity for tax reasons represent transactional complexity.

important insight into why the election seemed to reduce the tax law's complexity. Because complexity and burdens were treated as essentially interchangeable concepts,[261] the complexity generated by the introduction of the election was discounted since it was attractive complexity.[262]

Ignoring attractive complexity would only make sense if the sole harm caused by tax complexity is the burden complexity imposes on taxpayers. This is never the case, given that harms such as resource misallocation[263] and reduced taxpayer confidence in the fairness of the tax system[264] are inevitably associated with tax complexity. The distinction is crucial. If the problem is waste or cynicism, tax simplification is the proper solution. On the other hand, creating rules that taxpayers find more attractive and less burdensome is not a matter of tax simplification, but of tax deregulation.

Putting the check-the-box rules in context supports the conclusion that they were intended not as a simplification measure designed to make the tax law less complex, but rather as a deregulation measure designed to make the entity classification rules less subjectively burdensome by providing taxpayers with greater flexibility and choice. When the check-the-box rules were first announced, Washington was in the midst of adjusting to the Republican victory in the 1994 congressional elections. Congressional Republicans, concerned with the costs and constraints regulations imposed on businesses and individuals,

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261. *See supra* note 237.

262. The government's dialogue with the tax bar regarding proposed limitations on multiple classification changes illustrates why attractive complexity was ignored. Taxpayers fought limits to their ability to make elective classification changes even though those limits were, in part, intended to contain taxpayer costs. Presumably, this was because they believed that elective classification changes, even if costly, could never be burdensome but would always be beneficial because the costs of making such a change would always be outweighed by the tax and other benefits of making it. The real difference of opinion appears to have been whether the ability to make elective classification changes could ever be a burden to taxpayers. That difference turns on whether the term "burden" refers to the gross concept of costs or the net concept of costs offset by benefits. The regulations imposed limits on the ability of taxpayers to make frequent classification changes as part of its effort to discourage "a significant increase in the number of organizations changing their classification, thereby increasing burdens for some taxpayers and the Service." Notice 95-14, *supra* note 9, at 298. The New York State Bar Association objected to the limitation because "there appears to be no legitimate policy reason to impose such an artificial time limitation, particularly given that it is inconsistent with the policies behind the 'check-the-box' system." NYSBA 1996, *supra* note 207, ¶ 26. Notice 95-14 uses "burdens" as a synonym for "costs" and sees limitations on frequent classification changes as limiting those costs. On the other hand, the New York State Bar Association apparently failed to see any burden in multiple classification changes because any costs would be offset by greater benefits.

263. *See supra* note 18.

264. *See supra* note 50 and accompanying text.

fought to contain or reverse the growth of those burdens.[265] The Clinton administration[266] responded to that anti-regulatory push[267] with a plan of its own, one that emphasized the benefits provided by regulations.[268]

In a February 21, 1995 speech, President Clinton announced the administration's rejoinder to the Republican attempts to press their deregulatory agenda.[269] The Clinton administration attempted to steal the Republicans' thunder by embracing a "highly deliberative plan that tells regulators to inventory their rulemakings and come up with some to cut or change by June."[270] Both the timing and the content of Notice 95-14 support the conclusion that the check-the-box election was a part of that plan.

Although final regulations did not go into effect until the beginning of 1997, Notice 95-14, the first official announcement that elective entity classification rules were in the works, was published on April 3, 1995. The Notice was understood as a response to President Clinton's call for regulatory reform,[271] the initiative that formed the cornerstone of the

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265. The focus on the burdens and benefits of regulations is evident in the "regulatory budget" proposed by the Contract with America. Contract with America, The Job Creation and Wage Enhancement Act, http://www.house.gov/house/Contract/cre8jobsd.txt (last visited Jan. 31, 2005). One of the explicit goals of the regulatory budget was "forcing agencies . . . to identify regulatory policies whose benefits exceed their costs to the private sector." *Id.*

266. In the 1990s, Republicans such as Newt Gingrich may have been the more forceful advocates of regulatory reform, but the Clinton administration supported their own reform initiatives. The 1993 Clinton-Gore report, "From Red Tape to Results: Creating a Government That Works Better and Costs Less," underscored the extent to which the "consumer paradigm" had transformed the way politicians and the public viewed the relationship between individuals and businesses on the one hand and the government on the other. COHEN, *supra* note 16, at 396.

267. "This week the congressional calendar was jammed with 'regulatory reform' hearings, news conferences and floor debate—more evidence that the Republicans continue to move at warp speed to produce a grand plan to turn the federal regulatory system inside out, if not disable it." Cindy Skrzycki, *Clinton's Answer to a Juggernaut: Show Who Gets Hurt*, WASH. POST, Feb. 24, 1995, at F1, F1-2.

268. *Id*. (noting Clinton's emphasis on how private parties would be hurt by the proposed regulatory moratorium). It is noteworthy, that even though the consumer paradigm informed the regulatory reform proposals of both congressional Republicans and the Clinton administration, their respective approaches suggest starkly different visions of the role regulations play in the consumer paradigm. While conservative Republicans appeared to view regulations as inherently burdensome and therefore problematic, Clinton administration reforms such as the introduction of the check-the-box regulations, imply support for the position that simply eliminating regulations is not always in the interests of the private sector. *See, e.g.*, Hal Gann & Roy Strowd, *Reducing the Mounting Tax Compliance Burden*, 66 TAX NOTES 427, 427 (1995) (suggesting that well-designed tax regulations are often a net benefit to the business community).

269. Remarks on Regulatory Reform, 31 WKLY. COMP. PRES. DOC. 278 (Feb. 21, 1995).

270. Skrzycki, *supra* note 267; Remarks on Regulatory Reform, *supra* note 269, at 270 (quoting President Clinton as stating, "By June 1st, I want to know which obsolete regulations we can cut and which ones you can't cut without help from Congress.").

271. *See* Fleischer, *supra* note 111, at 518.

Democrats' answer to the Republican anti-regulation drive.[272] Significantly, the Notice did not merely indicate an intention to reform or even simplify the entity classification rules and its four-factor test. It specifically stated that an elective classification regime was on the administration's agenda.

Given that the announcement of the planned check-the-box regulations came a little over a month after Clinton's speech and before the announced June deadline, it seems unlikely that the timing of the Notice was accidental. The "remarkable speed"[273] with which the Notice's concept was transformed into proposed and then final regulations suggests that the rule change was not just business as usual, but also had an important political dimension. The source of that urgency, a desire on the part of the Clinton administration to demonstrate a commitment to creating regulations that on balance benefited rather than burdened private actors, is also the reason the Notice's proposal, making the entity classification rules elective, did not simplify the tax law. Because it was attractive complexity, the complexity produced by the check-the-box election did not conflict with the regulations' deregulatory aims.

C. Complex but Attractive

The key to the distinction between tax simplification and tax deregulation is that taxpayers view some complexity as beneficial, and therefore attractive, rather than burdensome. That a tax provision can be complex, resulting in significant resource waste by taxpayers and others, yet attractive instead of burdensome, makes a certain amount of intuitive sense. In some cases, the explanation may be a straightforward matter of dollars and cents.[274] In others, taxpayer preferences may have less rational origins.[275] The reason taxpayers responded so enthusiastically to

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272. *See* Skrzycki, *supra* note 267.

273. *See* Yin, *supra* note 164, at 125. Notice 95-14 was published in April of 1995. Final regulations were issued in December of 1996.

274. Rational choice would cause a low-income taxpayer to find the complex EITC attractive. It would also explain why a wealthy taxpayer might choose a return to the more complex world of tax shelters that existed before the creation of the passive loss rules. This would probably also be the reason middle-class taxpayers exhibit a preference for the complexities of the deduction for home mortgage interest. Whatever the cost of complying with those rules may be, that cost is outweighed by the tax benefits the rules provide.

275. Edward J. McCaffery & Jonathan Baron, *Thinking About Tax* 2 (Univ. S. Cal. CELO Research Paper No. C04-10, Univ. S. Cal. Law & Econ. Research Paper No. 04-13), *available at* http://www.psych.upenn.edu/~baron/253/thinking.pdf ("[T]ax and spending systems can be preferred for purely 'optical' reasons, notwithstanding real costs in terms of transactions costs and deadweight losses.").

the creation of the check-the-box election is probably a combination of the two.[276]

Rationally, taxpayers recognized the federal income tax savings that could be derived by using the numerous tax planning strategies[277] made possible by the check-the-box election. They also would have recognized the value of eliminating costly frictions such as the foreign tax implications of self-help classification changes.[278] The complexity a taxpayer would encounter in realizing those savings might not seem burdensome in light of the potential benefits available to taxpayers because of the election.

Less rationally, taxpayers' perceptions may also have been affected by the provision's nominal electivity. In the same way taxpayers will react more favorably to the same proposal characterized as a bonus for one group of taxpayers instead of a penalty for another,[279] taxpayers could have accepted the election's complexity because the election purported to offer taxpayers a choice.[280] Any taxpayer without the appetite for its complexity could choose not to confront it. No taxpayer is legally obligated, for example, to make a classification change. The fact that taxpayers were granted an option with the creation of the election rather than having a new obligation imposed on them may have made taxpayers view the election more favorably.

In this sense, taxpayers' preferences may not have been entirely rational. Semantics aside, check-the-box elections are no more or less elective than any other favorable tax provision. A business might choose not to incur the costs necessary to understand the possible implications of a check-the-box election for its tax obligations. A taxpayer may even choose not to make an obviously beneficial election. But even though taxpayers have the power to make or refrain from making check-the-box elections, few businesses would be certain that the aggregate entity- and owner-level taxes on their earnings will be minimized without understanding the check-the-box rules. Because of that, the complexity

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276. An additional factor may have been that Notice 95-14 offered taxpayers a choice between the four-factor test and the check-the-box election. Taxpayers' support for the change may have been more an expression of their approval of the four-factor test's demise than of the arrival of the election. By comparison with the 1960 regulations, even rules that might otherwise seem needlessly complex could appear quite reasonable. Alternatively, the non-simplifying benefits of the check-the-box regulations, such as the enhanced anti-association bias they produced, may have influenced taxpayer perception of the election.

277. *See supra* note 253 and accompanying text.

278. *See supra* note 251.

279. McCaffery & Baron, *supra* note 275, at 10.

280. It seems unlikely that taxpayers would have responded quite so enthusiastically to check-the-box elections if, for example, taxpayers were legally required to make an election whenever doing so would reduce their taxes.

of the check-the-box election is not truly optional.[281] Nevertheless, the fact that making an election is not explicitly required of any taxpayer may have made the complexity produced by the introduction of the check-the-box election attractive.

V. THE FUTURE OF TAX DEREGULATION

The report of the President's Advisory Panel on Federal Tax Reform,[282] suggesting ways to improve the nation's tax system, claims to have made "simplification a priority."[283] That claim is not supported by the details of the report's proposals. While intending to emphasize simplification, the report appears to have inadvertently made deregulation a priority. Relying on taxpayer preferences to identify sources of complexity and to gauge their importance undermined the Panel's ability to create effective simplification proposals. Because the Panel failed to recognize that taxpayers actually like some types of complexity, there is no reason to believe that even those aspects of the proposals[284] designed to simplify will reduce the amount of time and money devoted to the tax law.

This Part focuses on two of the report's recommendations: "reduc[ing] complexity by . . . [c]ombining 15 different tax provisions for at-work saving, health saving, education saving, and retirement

281. One can imagine a recent graduate forgoing the deduction for student loan interest provided by I.R.C. § 221 because gathering the required information and performing the necessary calculations would be "too complicated," thereby overpaying his taxes. That does not make the complexity of the student loan interest deduction elective in any meaningful sense. A rational taxpayer has no choice but to deduct student loan interest. Likewise a taxpayer has no choice but to make a favorable check-the-box election. The situation is even worse for taxpayers who collect all of the relevant information and perform all of the necessary calculations only to discover that they are not eligible for the deduction or that a check-the-box election would not be favorable. For those taxpayers the deduction and the election are simply a waste of time.

282. PRESIDENT'S ADVISORY PANEL ON FED. TAX REFORM, SIMPLE, FAIR, AND PRO-GROWTH: PROPOSALS TO FIX AMERICA'S TAX SYSTEM, FINAL REPORT, *available at* http://taxreformpanel.gov/final-report/ [hereinafter FINAL REPORT] (last visited Nov. 7, 2005).

283. *Id.* at 51.

284. The report's proposals balance its simplification goals against competing policy objectives. As a result, fully implementing those proposals would not necessarily result in a tax system that consumes fewer of society's resources, using today's system as a baseline. Determining whether the Panel's proposals achieve their simplification goals by measuring the resources taxpayers and the government devote to meeting their obligations before and after implementation of the reforms would be like trying to determine whether your furnace is producing heat by measuring the change in temperature in your house from one day to the next. Even if the furnace is on, a change in the weather might make your house cooler. To know whether the furnace is producing heat, you need to determine whether your radiator is hot. Similarly, determining whether the proposed simplification reforms actually simplify requires isolating the aspects of the proposals actually intended to produce greater simplicity and determining whether they would succeed.

saving into three simple savings plans"[285] and "simplifying tax benefits for charitable giving . . . ."[286] The first demonstrates how heavily the Panel relies on taxpayer preferences to identify complexity and to create simpler alternatives. That reliance causes the report to propose a change that the Panel believes taxpayers would welcome, which the Panel inappropriately interprets as proof that the change would simplify. The same focus on taxpayer preferences causes the second proposal to fail because the Panel ignores significant amounts of attractive complexity.

A. Tax-Preferred Savings

The Panel's report suggests "a comprehensive package of savings proposals designed to allow Americans to save in a simple and efficient manner."[287] One change "would combine the panoply of savings incentives and accounts into three simple and flexible opportunities: (1) Save at Work plans; (2) Save for Retirement accounts; and (3) Save for Family accounts."[288] The Panel concludes that "[c]ombining 15 different tax provisions . . . into three simple savings plans" would reduce complexity.[289] To reach that conclusion, the report makes two flawed assumptions. First, it assumes that reducing the number of savings options would reduce the cost of using tax-preferred savings vehicles. It also assumes that those costs explain taxpayers' aversion to tax-preferred saving.

The Panel points to the testimony of a witness that under current law taxpayers are "paralyzed by the range of tax-preferred savings choices" to the extent that they "may choose to spend their money rather than save it for the future simply because it is an easier decision."[290] The Panel reasons that taxpayers' aversion to the current array of options is a rational response to the effort and expense required of taxpayers to make use of them. It therefore proposes a smaller number of tax-preferred savings vehicles[291] to "diminish the need for taxpayers to hire tax

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285. FINAL REPORT, *supra* note 282, at xii.

286. *Id.* at 60.

287. *Id.* at 114.

288. *Id.* at 115. The proposal is very similar to earlier proposals by President Bush to create new tax-preferred savings accounts. *See, e.g.*, Press Release, Dep't of the Treasury, President's Budget Proposes Bold Tax-Free Savings and Retirement Security Opportunities for All Americans, *available at* http://www.ustreas.gov/press/releases/kd3816.htm (last visited Feb. 16, 2006).

289. FINAL REPORT, *supra* note 282, at xii.

290. *Id.* at 91.

291. In addition to differences in eligibility criteria and contribution limits, one of the most important distinctions among the existing options are the circumstances in which taxpayers are permitted to make early withdrawals without penalty. *Compare* I.R.C. § 72(t)(2)(B) (2000) (permitting penalty-free withdrawals for medical expenses from qualified retirement plans) *with*

professionals to help them navigate the tax code's multitude of incentives" and to minimize the need for taxpayers "to jump through hoops to make sure that they maximize their after-tax returns."[292]

The reforms could help taxpayers spend less time and money determining which tax-preferred savings vehicles would best suit their needs. Of course, the same might be true if a toolbox were emptied of 80% of its tools. With fewer tools available, a laborer might spend less time selecting the best tool for a given task. However, in both cases, the impact of the change on the ability of the saver or the laborer to accomplish their task is not merely a function of the number of available tools. Fewer tools may mean less effort spent choosing a tool, but it may also make completing common tasks more difficult. If useful tools are eliminated, fewer may mean more effort rather than less.

One saver's tool that the Panel proposes to eliminate[293] is the retirement savings account that permits taxpayers to save simultaneously for retirement and for certain extraordinary current expenses.[294] The effect of eliminating such hybrid accounts on taxpayers' out-of-pocket and other costs is not obvious. Even if it relieves taxpayers of the expenses related to choosing among a number of options, they may spend a comparable amount of time and money deciding which of the few remaining options will allow them to achieve their objectives.[295] Faced with limited options, taxpayers may spend still more time improvising methods of saving for retirement while ensuring that assets will be available to satisfy extraordinary pre-retirement expenses.[296] Reducing the number of options available could well increase, rather than reduce, the economic costs of tax-preferred saving.

The Panel is wrong to suggest that taxpayer preferences can be relied on to reveal the most important sources of complexity. Whatever the reason for taxpayers' strong aversion to choice in this context, the economic cost of choice for taxpayers appears to be an unlikely culprit.

I.R.C. § 72(t)(2)(F) (2000) (permitting penalty-free withdrawals for a first-time home purchase from "individual retirement accounts").

292. FINAL REPORT, *supra* note 282, at 93.

293. *See id.* at 92.

294. *See, e.g.*, *supra* note 291 and accompanying text.

295. Determining how to save for retirement without limiting the funds available for extraordinary medical expenses will be more difficult rather than less under the proposed regime. That might be important for older taxpayers. Younger taxpayers might have difficulty balancing the desire to begin saving for retirement as soon as possible against the need to set money aside to purchase a first home. Deciding how to save will remain difficult even with fewer savings options because taxpayers' objectives will not necessarily fall neatly into distinct categories.

296. For example, taxpayers may be forced to improvise ways to borrow against their retirement savings to fund extraordinary medical expenses.

If that aversion is not rational[297] or taxpayers have reasons other than those identified by the Panel for preferring less choice, even successfully reducing taxpayers' costs will not solve the taxpayer preference problem the Panel has identified. Even if taxpayers were to embrace the idea of diminished choice, that would hardly prove that restricting choice had made the tax law simpler. All it would prove is that taxpayers preferred the complexity of the new system over that of the old.

B. The Charitable Deduction

The proposed charitable contribution deduction is designed to serve two primary purposes. In addition to "simplify[ing] the deduction for charitable contributions"[298] the revised deduction is also intended to be "available to more taxpayers"[299] than are eligible under the current regime. Making the deduction available to more taxpayers obviously makes the deduction's per-taxpayer complexity more expensive in the aggregate.[300] Nevertheless, taking the expansion of the deduction's availability as a given, reducing the per-taxpayer resource cost of the deduction would constitute a simplification change.

The report proposes simplifying the deduction by adding a new limitation. The new limitation would prohibit a taxpayer from deducting charitable contributions to the extent they amount to less than 1% of the taxpayer's income.[301] According to the Panel, this "would reduce the recordkeeping burden and the potential for cheating on small deductions, which are not cost-effective for the IRS to verify. Taxpayers who give less than 1 percent of their income would not need to keep any records."[302] Because taxpayers that make few charitable contributions would be ineligible for the deduction, they would have no reason to

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297. Taxpayers might express a preference for fewer savings options even though fewer options might impose greater costs on them simply because they are familiar with the costs the current system imposes on them but not with the costs they would bear under an alternative system. That familiarity may cause taxpayers to overstate the significance of the complexity associated with having a variety of choices.

298. FINAL REPORT, *supra* note 282, at 75.

299. *Id.* The deduction is currently available only to those taxpayers who "itemize" their deductions. The new deduction would be available to any taxpayer, to the extent that she contributes more than 1% of her income to charity.

300. If twice as many taxpayers must determine their eligibility for the deduction and calculate its impact on their tax obligations, more overall taxpayer time and effort will be devoted to understanding the implications of the deduction.

301. FINAL REPORT, *supra* note 282, at 76.

302. *Id.* One could reasonably conclude that an unstated purpose of the 1% limitation is to blunt the revenue impact of making the deduction available to taxpayers who do not itemize. However, unless the Panel intended to deceive by calling the change a simplification measure, it must have believed that the change would also simplify.

collect or keep receipts from their few contributions. As a result, the limitation would meaningfully reduce[303] costs attributable compliance complexity.[304]

In reaching the conclusion that the 1% limitation simplifies, the Panel ignores a significant amount of attractive complexity. For example, taxpayers contributing neither a very small nor a very large amount to charity will not necessarily know whether they will be entitled to a tax deduction for their contributions in each year. Given that uncertainty, a taxpayer will have an incentive to alter his behavior to control whether or not his donations qualify for a deduction.

By waiting until December to make donations, for example, a taxpayer might be in a better position to determine whether his donations will be made out of pre-tax or after-tax dollars and to adjust the amount of the contributions accordingly.[305] Alternatively, a taxpayer may choose to "bunch" deductions that he might otherwise make over several years into a single year in order to donate more to charity at the same after-tax cost. Crafting and carrying out such strategies would impose real costs on taxpayers. Although that transactional complexity would be attractive complexity,[306] it could well overwhelm the simplifying effect of the limitation. By ignoring that attractive complexity, the Panel confused simplification with deregulation.[307]

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303. The reduction is certainly not as great as the Panel suggests. It assumes that taxpayers who do not qualify for the deduction will not need to keep receipts or perform calculations. However, many taxpayers who ultimately fail to qualify will need to do precisely that to determine whether their charitable contributions exceed 1% of their income in any given year.

304. The report appears to conclude that compliance complexity is the complexity that taxpayers find most objectionable. For example, it cites polling data indicating that the process of completing and filing tax forms "is so bad that one-third of Americans surveyed believe that completing the annual tax return is more onerous than actually paying large amounts of money in taxes." FINAL REPORT, *supra* note 282, at 2. As a result, the report places considerable emphasis on shortening forms and eliminating schedules. This may help to explain why the Panel focuses on the potential reduction in compliance complexity while ignoring the transactional complexity discussed below.

305. For example, a taxpayer who wants to contribute a fixed amount on an after-tax basis would contribute more if she were eligible for a deduction than if she were not. By waiting until the end of the year, a taxpayer would have more information about his income and therefore be in a better position to calculate the tax consequences of a donation.

306. A rational taxpayer would only bear those costs if they were expected to produce an economic benefit to the taxpayer sufficient to more than offset the costs. Incurring these planning costs would leave a taxpayer economically better off than she would otherwise be.

307. Replacing complexities that taxpayers find burdensome (such as collecting receipts for charitable contributions) with equally costly complexities that taxpayers have reason to find attractive (such as determining the optimal strategy for maximizing the deductibility of charitable contributions) is not simplification. However, if taxpayers find the latter source of complexity less burdensome, it would constitute deregulation regardless of its resource impact.

VI. CONCLUSION

Political failure has long been the scapegoat for the increasing complexity of the income tax. Over the last few decades, confusion over the meaning of the term "simplification" appears to have become a second important obstacle to creating simpler tax laws. Because some tax complexity is attractive to taxpayers, relying on taxpayer preferences to identify complexity and to guide simplification efforts has produced reforms and proposals that promise simplification but instead deliver pro-taxpayer deregulation that may cause more of society's resources to be devoted to paying, minimizing, and collecting taxes rather than less. The check-the-box election, which provided taxpayers with greater flexibility to choose and change the classification of business entities while having only an ambiguous impact on the tax law's complexity, offers a clear example of the misidentification of a deregulatory reform as a simplification reform. The simplification proposals offered by the bipartisan tax reform panel in 2005 would have done an equally poor job of simplifying the tax law.

A rational taxpayer will always embrace a complex tax rule when its economic costs (e.g., $100 in time and legal fees) are more than offset by tax benefits the rule facilitates (e.g., $101 in tax savings). Although that rule's complexity is attractive to taxpayers, it still consumes $100 of society's resources. To prevent attractive complexity from transforming tax simplification into tax deregulation, it is important to adopt an objective approach to identifying and measuring complexity. Recognizing that rational taxpayers will sometimes prefer complexity over simplicity will help prevent attractive complexity from undermining the success of efforts to simplify the tax law. Combining these insights with the nation's increasing awareness of the importance of simpler tax laws may finally put simplification within reach. Continuing to treat tax deregulation as a substitute for tax simplification will ensure the continued failure of efforts to make the tax law simpler.