# CPA Outlook Serves as Economic Bellwether

Depending on which newspaper one reads on any particular day, the country is either in the midst of an economic recovery or on the precipice of another recession. CEOs rely on multiple indicators, including news reports, to predict the future financial health of state and local economies, but there is one economic bellwether they might be overlooking—their own CPAs.

As intrinsic role-players in a business's future financial planning, CPAs are uniquely equipped to provide insight on the health of the larger economy. With this in mind, the NYSSCPA surveyed nearly 600 of its members—including those in industry, government, and public firms—in early autumn and asked them to provide their perspective on the current and future economic health of the national, state, and local economies; how they rated our state and national leaders within an economic context; and what they expected from our state's regional industries in the coming year. Although similar polls tracking CPAs' perspectives on a national level exist, the Society's survey is the only one that provides New York CPAs' economic outlook for 2013.

The online survey was emailed to all NYSSCPA members for whom the Society has an email address (approximately 16,000 members). It represents member perspectives in industry, public firms, and government throughout New York State. A third-party research firm, Stanford H. Odesky and Associates, analyzed and prepared the results, which carry a ±4% margin of error with a 95% confidence level.

## A Review of the Results

We found that nearly 60% of Society members largely feel that business conditions here in New York will remain the same over the next six to twelve months, with about half of the respondents believing that the unemployment rate will remain flat in the near future. Members located in the New York City region, however, have a more optimistic outlook; approximately 35% of respondents in New York City's five boroughs believe the state economy will improve compared to the approximately 27% of total respondents who had a positive outlook for the state. (This survey was conducted prior to superstorm Sandy's arrival in the Tri-State Area at the end of October.)

In terms of their political outlook, our members told us they were satisfied with Governor Andrew Cuomo's economic policies, a trend that largely matches the general public's opinion; however, more than 73% of respondents were not satisfied with the level of small business tax credits available to New York business owners. Perhaps unsurprisingly, Society members also indicated business taxes, personal taxes, and property taxes were all too high.

Looking forward, NYSSCPA members polled said they believe finance (22%), healthcare (18%), and tech industries (15%) will play the biggest role in New York State's economy. More than 50% of the total members polled said that cloud computing or database security and improvements will be the technological advancement most businesses will focus on in the coming year; 15% said businesses will take advantage of mobile device integration applications. In terms of their own businesses, nearly 47% of members statewide said that instances of slow-pay were the biggest issue they faced from clients. Our members foresee New York businesses expanding their operations about as much as they did in the past; however, a majority of members in the Hudson Valley (55%) anticipate less expansion than in the past.

President Obama didn't fare as well as our Democratic governor: 64% of respondents were dissatisfied with Obama's economic policies, and 60% said his reelection would negatively impact on the economy. Two-thirds of respondents felt that Governor Romney would have positively impacted the economy had he been elected.

With Obama's re-election, the Affordable Care Act (ACA) will continue on the road toward its 2014 implementation. Seven in ten NYSSCPA members consider themselves familiar with the legislation (15% "very familiar"; 60% "somewhat familiar"). In the case of Society members, it seems that familiarity does breed contempt, at least when it comes to the ACA; 67% of respondents believe Obamacare will negatively impact small businesses. Slightly more than half of the members polled said the healthcare law will not be good for large businesses, either. Only 18% believe the ACA will significantly change the way they do business, and 38% anticipate no change at all.

The other major issue resonating from Washington is the continued negotiations over how to best avoid the fiscal cliff. In his victory speech following the election, President Obama mentioned his desire to reform the tax code. And with the Bush tax cuts set to expire, we are all bracing for what could be a dramatic change in the financial structure of this economy. Our members are divided on what impact the current proposed changes in the gift and estate taxes for 2013 will have on their clients, with 50% predicting an insignificant impact and 43% anticipating a negative impact. Of course, current proposals may change at any time.

## An Uncertain Future

These are just some of the highlights of our survey results. CPAs, through their clients and businesses, have a pulse on the economy. The coming year will determine whether our state and nation's economic health improves, falters, or—as most of our members predict—remains the same. For the full economic perspective of what our members expect for the national, local, and regional economy in 2013, visit the Society's website, www.nysscpa.org. ❑

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Rogers to Ronald Reagan. According to Scott Moody, tax law complexity has been the subject of complaints since 1914, shortly after adoption of the constitutional amendment allowing the income tax ("The High Cost of Compliance," *Human Events*, vol. 57, no. 30, Aug. 13, 2001, pp. 12-14). Yet, little or nothing has come from the repeated jabs at our income tax laws and calls for simplicity. The cause for complaints has become more dramatic in recent years. Moody cites a Tax Foundation study listing the length of the IRC at 172,000 words in 1955, but 982,000 in 2001. The Treasury Regulations grew even faster, from 572,000 words in 1955 to 5,947,000 words in 2001.

How does the United States compare to other countries regarding tax law complexity? Not as poorly as one might think. According to a study conducted by PricewaterhouseCoopers, World Bank, and International Finance Corporation, the United States ranked 69th (out of 183 countries) in terms of the ease of tax compliance ("Paying Taxes 2012: The Global Picture," http://www.pwc.com, p. 115). This was due in part to the concreteness of U.S. income tax law—while the laws may be complex, they are certain.

Why should individual taxpayers, preparers, or politicians be concerned about tax law complexity? Basically, it comes down to the efficient allocation of resources: manpower, paper output, computer capacity, and intellect. Hours spent developing, administering, and applying our intricate income tax laws could be better spent on activities that advance the gross domestic product (GDP) or help solve other social problems.

What are some of the negative consequences of tax law complexity from the perspective of the individual taxpayer? Complexity hinders taxpayers' understanding of tax returns, while increasing the cost of tax compliance (the proliferation of secondary resources—e.g., Common Clearing House [CCH], Research Institute of America [RIA] —is evidence of this high cost of tax compliance). The combination of these two outcomes also results in a loss of taxpayer confidence in tax returns and the preparation process.

The following is an examination of the readability of income tax law as promulgated by three government entities: the U.S. Congress, the U.S. Treasury, and the IRS. If one government entity can be identified as more responsible for tax law complexity, focusing efforts at reforming that entity will have the most impact.

## Background

According to one survey of experts, the factors that contributed most to the complexity found on Form 1040, U.S. Individual Income Tax Return, were fre-

**EXHIBIT 1**
Readability of the IRC, Treasury Regulations, IRS Instructions, and Other Documents

| | Flesch Reading Ease Score | Flesch-Kincaid Grade Level Score | Passive Sentence Percentage |
|---|---|---|---|
| SFAS 94 | 1.8 | 19.8 | 29 |
| SFAS 10 | 9.7 | 18.7 | 38 |
| SAS 1 | 16.6 | 16.5 | 17 |
| Clean Air Act, amended (1990) | 19.2 | 15.3 | 6 |
| Pollution Prevention Act (1990) | 20.6 | 14.8 | 10 |
| Freedom of Information Act (1966) | 21.5 | 18.9 | 25 |
| IAS 41, Agriculture | 25.3 | 15.2 | 31 |
| SFAS 50 | 29.6 | 15.4 | 47 |
| **IRC section 1221 Capital Gain Defined** | **29.8** | **14.2** | **6** |
| *This manuscript* | *31.9* | *13.8* | *5* |
| **Treasury Regulation on Capital Gain** | **31.4** | **15.7** | **6** |
| IAS 20, Government Grants | 35.7 | 14.9 | 61 |
| Declaration of Independence | 37.5 | 15.1 | 11 |
| Bill of Rights | 43.0 | 14.4 | 25 |
| U.S. Constitution | 49.5 | 12.6 | 33 |
| **IRS Capital Gain Instructions** | **53.7** | **9.8** | **7** |
| *A Time to Kill*, by John Grisham (5 pages) | 84.6 | 3.4 | 4 |

quent change, excessive detail, ambiguity, burdensome recordkeeping, numerous calculations, and confusing forms (Susan Long and Judyth Swingen, "An Approach to the Measurement of Tax Law Complexity," *The Journal of the American Taxation Association*, Spring 1987, pp. 22–36). Capital gain/loss income tax laws, the subject of this article, were ranked as the most complex of the 39 tax items examined.

Another survey examined the impact of tax law complexity—specifically, reading complexity and content complexity—on tax professionals' understanding of the law (Stewart Karlinsky and Bruce Koch, "Impact of Tax Law Complexity on Professionals," *The Journal of the American Taxation Association*, Fall 1987, pp. 24–34). The present article focuses on reading complexity (e.g., sentence length, word length), because it is the complexity measure most readily available for revision and improvement.

A survey of tax practitioners and educators found agreement that complexity was an issue needing congressional attention (Davies 2011). The top three issues identified as complex were the alternative minimum tax, passive activity losses, and at-risk rules. Respondents ranked capital gain/loss income laws as the ninth most complex tax item of the 39 IRC provisions examined.

A survey of accounting professionals found that the "technical level of the writing" was the number one cause of complexity in financial reporting law, closely followed by "ambiguity in the standard" (Steve Wells, Doug Barney, and Dan Tschopp, "Complexity in U.S. GAAP," *Journal of Business, Industry, and Economics*, vol. 10, Spring 2008, pp. 57-80). The authors concluded that "CPAs feel that GAAP standards, even on technical or specialized topics, can be written in less complex form." Logically, this same conclusion should apply to tax law. This analysis will evaluate the tax law complexity of the IRC, Treasury Regulations, and IRS documents with the goal of determining which originating entity is relatively most responsible for tax law complexity.

## Evaluating Readability

Using standardized readability indices, the authors evaluated the IRC, Treasury Regulations, and IRS documents dealing with the capital gain/loss income tax law. Comparing all three sources for one tax topic reduces the impact of the technical aspect of the law on the outcome. A primary advantage of this method over previous research is an objective evaluation of the readability index that does not rely upon interpretations and respondents' subjective evaluations. The authors used a relatively sophisticated measure of readability unused in previous tax complexity studies.

The researchers examined the material using the Flesch Reading Ease (FRE) scoring system, the Flesch-Kincaid Grade Level (FKGL) scoring system, and the percentage of passive sentences; these calculators are readily available online.

The FRE evaluates text on a 100-point scale. Text that is easier to read scores higher on the scale. The FRE score is calculated as follows:

206.835 − (1.015 × [words per sentence]) − (84.6 × [syllables per word])

The FRE results are categorized as easy to read (e.g., a children's book), average (e.g., high school level), moderate (e.g., *Time* magazine), or difficult.

The FKGL test rates readability using U.S. school grade levels. The formula for the FKGL score is:

(.39 × [words per sentence]) + (11.8 × [syllables/per word]) − 15.59

The authors also examined the percentage of passive sentences in each document. A passive sentence is one in which the subject of the sentence does not perform the action denoted by the verb in the sentence. Because the active voice is clearer and more precise, the passive voice increases reading complexity.

## Results

*Exhibit 1* provides the comparative results of the three readability tests for the IRC, Treasury Regulations, and IRS instructions and other documents. In an effort to provide some context for discussion, the authors also analyzed the reading ease of other U.S. laws, founding documents for the U.S. government, U.S. financial accounting standards, IFRS, this article, and one novel by John Grisham.

***Flesch reading ease.*** With FRE scores of 29.8 and 31.4, the U.S. Congress and U.S. Treasury, respectively, could take writing lessons from the Founding Fathers. The Declaration of Independence, the Bill of Rights, and the Constitution scored between 37 and 50 on the FRE scale; all are easier to read than the capital gain/loss laws written by the U.S. Congress and U.S. Treasury. While critics could argue that these documents don't go into details, they were written to be understandable to a vast percentage of the populace. This should be desirable for tax law as well.

Readability increases as capital gains law passes from the originating authority (Congress), to refinement (U.S. Treasury), to implementation (IRS regulations). The IRC and Treasury Regulations are both difficult reading (FRE score of 30). The IRS instructions, however, are only moderately complex reading. Apparently the IRS has done its job in simplifying capital gains law. While there is room for the IRS to further simplify its instructions, the instructions are already easier to read than numerous other government documents, as well as this article. Reading this article is about as difficult as reading the IRC and Treasury Regulations on capital gains and losses. The IRS Instructions provided easier reading and, in fact, were the easiest reading on the list, other than the novel.

***Flesch-Kincaid Grade Level.*** Understanding the IRC definition of capital gains and losses requires approximately 14 years of education. The opening sentence of IRC section 1221 is 483 words long. The sentence uses passive voice and provides a list of items not defined as capital assets:

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include …

The authors suggest that Congress can reduce much of tax law complexity through simple rewrites of existing law. For example, the above passage could read:

> For purposes of this subtitle, "capital asset" is taxpayer property except the property specifically listed below.

The section could then continue by listing each exception as a separate sentence or bullet point.

The Department of the Treasury has apparently further complicated the discussion, resulting in the need for a college degree in order to comprehend the Treasury Regulations on capital gains and losses.

Capital gain/loss law is easier to read than numerous other laws examined. In fact, understanding the IRC and Treasury Regulations requires about the same level of education as the Declaration of Independence, Bill of Rights, and Constitution; the IRS instructions require less education. The IRS has done impeccable work in generating capital gain/loss instructions understandable by ordinary individuals, the majority of whom have no need to read and understand this law.

***Passive voice.*** The IRC, Treasury Regulations, and IRS publications all made good use of active voice, receiving passive voice scores of 6%. Passive voice generally requires more words to say the same thing as the active voice. Therefore, passive voice statements are harder to decipher than active voice statements.

All three IRS documents made outstanding use of active voice. The only documents analyzed with fewer passive voice sentences were the Clean Air Act, this article, and the John Grisham novel.

The opening sentence of the IRS publication defining a capital asset uses active voice and is only 16 words long: "Most property you own and use for personal purposes, pleasure, or investment is a capital asset." While the IRS publication has many complicated passages, this document is closer to the readability of a John Grisham novel than either the IRC or Treasury Regulations.

## Reducing Complexity

Tax law is a complex topic, due to its technical nature and the influence of various interests over the law. With so many interested parties involved, it would be difficult to make the tax law shorter (and the technical aspect of income tax law will always be present), but it might be possible to increase the readability of the text. Increased readability would reduce compliance costs and increase taxpayer confidence.

There is a pattern to the FRE, FKGL, and passive voice results found by the authors. Readability actually increased as the capital gain loss income tax law passed through origination, refinement, and implementation. For all the complaining by taxpayers about the complexity of IRS publications, they were actually the least complex of the documents released by Congress, the Treasury, and the IRS. Now one has some basic idea of the complexity added by each government entity.

There are several approaches available to address this complexity: The originating entity could review each law, document, and form with the objective of improving its readability score. Or the entities could eliminate sections entirely, as has been repeatedly proposed for the Alternative Minimum Tax. Finally, the United States could switch tax systems entirely, such as to a flat tax or value-added tax. Any of these approaches would require recognition on the part of government that reform is necessary. ❑


## FOR FURTHER READING

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# Rewarding Whistleblowers for Disclosing Tax Violations to the IRS

*By R. Scott Oswald*

In 2006, Congress revamped the IRS's program for rewarding informants who disclose tax violations. The first beneficiary of the new program was a CPA, who received a $4.5 million reward when he discovered and disclosed a tax liability greater than $20 million at a large national financial services firm. The discussion below provides an overview of the program, the requirements for disclosure, certain confidentiality rules for financial advisors, and protections under the law.

## How It Works

Under the IRS Whistleblower Reward Program, an individual who exposes tax fraud can receive an award ranging from 15% to 30% of the proceeds recovered by the IRS. To qualify for an award, the tax, penalties, interest, additions to tax, and additional amounts in dispute must exceed $2 million; if the allegedly noncompliant person is an individual, the individual's gross income must exceed $200,000.

In such cases, the IRS first completes an investigation and then its Whistleblower Office issues a preliminary summary. The whistleblower then has 30 days to respond and argue for an increased award. The whistleblower is also given the opportunity to meet with the whistleblower office and review the documents used in determining the award; then, a final determination is issued on the amount of the award. If whistleblowers believe that the award does not adequately reflect their contributions, they may appeal the IRS's decision to the Tax Court within 30 days.

The potential areas for award are only limited by the ways a taxpayer can violate the Internal Revenue Code (IRC). These violations include obvious misdeeds, such as deliberately underreporting or omitting income, claiming false deductions, hiding or transferring assets or income, and making false entries in records; they also extend to the nefarious, such as maintaining two sets of books, misusing trusts, or abusing charitable deductions. Beyond these specific violations, many other areas are ripe for whistleblower disclosures—for example, a taxpayer's use of offshore accounts, tax shelters, or shell companies.

It is important to remember that whether the taxpayer is aware of the violation is immaterial; the violation itself gives potential whistleblowers grounds for disclosure.

## Requirements for Disclosure

Ideally, an IRS whistleblower can offer specific information about a taxpayer's tax violations and can provide the IRS with proof that actually supports those claims. The disclosure needs to have the hallmarks of credibility, not speculation or hearsay.

The IRS is looking for something more. Disclosures made by employees of taxpayers—such as bookkeepers or executive assistants—who have access to financial records are ideal. The IRS seeks whistleblowers with inside knowledge of undisclosed fraudulent transactions and the documentation to support the disclosure. In addition, the disclosure should be based on original information; disclosures based on media or governmental reports are disfavored and will lessen the amount of a potential reward.

## Professional Obligations

One important note merits highlighting: professional organizations (such as the AICPA and NYSSCPA) have specific rules regarding the disclosure of confidential information that CPAs receive from clients. For example, part 29-10(c) of the New York State Rules of the Board of Regents prohibits a CPA from revealing personally identifiable facts, data, or information obtained in a professional capacity without the client's prior consent. As another example, Rule 301 of the NYSSCPA Code of Professional Conduct states that a "member who practices public accountancy shall not disclose any confidential client information, nor disclose any confidential employer information, obtained in the course of performing professional services without the specific consent of the client or employer" (http://www.nysscpa.org/ezine/ETPArticles/2011/10611/qepc_5.htm).

Potential whistleblowers must weigh these professional obligations when deciding whether to disclose violations to the IRS Whistleblower Office.

## Protection under the Law

Potential whistleblowers—especially employees of an offending taxpayer—often wonder what kind of protections the law affords them. Many statutes encouraging whistleblowers contain antiretaliation protections for employees who disclose transgressions of their employers, including the Sarbanes-Oxley Act of 2002, among others.

But the IRS whistleblower program lacks such protections. At this time, no statutory provisions protect IRS whistleblowers against retaliation by their employers. Instead, the IRS focuses on protecting whistleblowers by keeping their identity confidential to the fullest extent possible. Despite this, the IRS might reveal a whistleblower's identity if it is necessary to continue the investigation. If the IRS chooses to reveal a whistleblower's identity, it "will inform the whistleblower before deciding whether to proceed" (IRC section 7623). These identity-protecting regulations are a weak protection for whistleblowers from employer retaliation.

But there is some hope: the CPA who received the first reward under the new program has remained anonymous. The financial services firm never learned his identity and he was never publicly identified by the IRS.

## A Public Service

Potential whistleblowers have the opportunity to do a great service in aiding to return funds to the public purse where they belong. These whistleblowers can be rewarded for enticing the IRS by making disclosures accompanied by substantial and credible information. ❑

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