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## The Complexity of the Tax Code

### DEFINITION OF PROBLEM

The most serious problem facing taxpayers — and the IRS — is the complexity of the Internal Revenue Code (the “tax code”). Among other things, the tax code:

- Makes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns;
- Requires the significant majority of taxpayers to bear monetary costs to comply, as most taxpayers hire preparers and many other taxpayers purchase tax preparation software;
- Obscures comprehension, leaving many taxpayers unaware how their taxes are computed and what rate of tax they pay;
- Facilitates tax avoidance by enabling sophisticated taxpayers to reduce their tax liabilities and by providing criminals with opportunities to commit tax fraud;
- Undermines trust in the system by creating an impression that many taxpayers are not compliant, thereby reducing the incentives that honest taxpayers feel to comply; and
- Generates tens of millions of telephone calls to the IRS each year, overburdening the agency and compromising its ability to provide high-quality taxpayer service.

In 2012, TAS conducted a statistically representative national survey of over 3,300 taxpayers who operate businesses as sole proprietors. Only 16 percent said they believe the tax laws are fair.<sup>1</sup> Only 12 percent said they believe taxpayers pay their fair share of taxes.<sup>2</sup> The National Taxpayer Advocate finds this extraordinary lack of public trust in the method by which our government is funded profoundly disturbing.

To alleviate taxpayer burden and enhance public confidence in the integrity of the tax system, the National Taxpayer Advocate urges Congress to vastly simplify the tax code. In general, this means paring back the number of income exclusions, exemptions, deductions, and credits (generally known as “tax expenditures”). For fiscal year (FY) 2013, the Joint Committee on Taxation has projected that tax expenditures will come to about \$1.09 trillion,<sup>3</sup> while individual income tax revenue is projected to be about \$1.36 trillion.<sup>4</sup> This suggests that if Congress were to eliminate all tax expenditures, it could cut individual

<sup>1</sup> Russell Research, Inc., *Factors Influencing Compliance: Topline Summary* (May 2012). Russell Research conducted this survey for TAS. A detailed presentation and analysis of the survey results is published in Volume 2 of this report. See Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*.

<sup>2</sup> *Id.*

<sup>3</sup> See Staff of the Joint Committee on Taxation, 112th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015* (Joint Comm. Print 2012), at <https://www.jct.gov/publications.html?func=select&id=5>.

<sup>4</sup> See Office of Management and Budget, Budget of the United States Government, Fiscal Year 2013, Historical Tables, Table 2.1, at <http://www.whitehouse.gov/omb/budget/Historicals>.

income tax rates by about 44 percent and still generate about the same amount of revenue.<sup>5</sup> The Treasury Department also makes annual tax expenditure estimates, and for FY 2013, it projects tax expenditures of \$1.02 trillion, which would allow for a 43 percent reduction in tax rates under similar assumptions.<sup>6</sup>

As this report goes to press, we are well aware that the subject of tax reform is figuring prominently in the political dialogue over ways to reduce the federal budget deficit. The National Taxpayer Advocate does not take a position regarding optimal revenue levels, tax rates, or the distribution of tax liabilities. As the statutory voice of the taxpayer, the National Taxpayer Advocate is recommending tax reform for the purpose of reducing taxpayer burden. As discussed below, the existing tax code inflicts significant, even unconscionable, burden on taxpayers, and Congress could alleviate much of that burden by vastly simplifying the tax code. Thus, our advocacy for tax reform is longstanding and wholly unrelated to deficit reduction.

In 1986, the last time Congress enacted fundamental tax reform, the legislation proceeded on a revenue-neutral basis. That approach had the virtue of allowing policymakers to assure taxpayers that, at least on average, their tax bills would not rise. If tax reform is undertaken now as part of an effort to raise revenue, that assurance cannot be given. But the same structural tradeoffs will apply. Once Congress sets its revenue targets, it can hit its targets by enacting relatively high tax rates that continue to be offset by a bewildering array of exclusions, exemptions, deductions, and credits, or it can hit its targets by enacting relatively low tax rates and minimizing the number of tax breaks it permits.

From the standpoint of reducing taxpayer burden, simpler is better. As we have suggested in the past, we recommend that Congress employ a “zero-based budgeting” approach to tax reform. The starting point for discussion would be a tax code without any exclusions or reductions in income or tax. A tax break or IRS-administered social program would be added only if lawmakers decide, on balance, that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity burden that the provision creates for taxpayers and the IRS. At the end of the exercise, tax rates can be set

<sup>5</sup> We cite this figure as a ballpark estimate. There are at least two important effects that could cause this percentage to be higher or lower in practice. First, if all tax expenditures were eliminated, each taxpayer's taxable income would increase substantially (e.g., by 44 percent), and as taxable income rises, taxpayers move into higher marginal tax-rate brackets. Therefore, the additional taxable income would fall into the higher bracket levels, causing taxpayers to pay more in tax. This mechanical effect suggests Congress could cut tax rates by more than 44 percent and still raise the same amount of revenue. Second, tax expenditures have certain interactive effects that tend to push in the opposite direction. Thus, if all tax expenditures were eliminated simultaneously, the interactive effects would probably cause the additional tax revenue to be somewhat less than the sum of the tax expenditures eliminated. TAS does not have a revenue-estimation capacity, so we cannot determine whether the combination of these effects would, on balance, produce more revenue or less revenue. Nevertheless, the aggregate total provides a rough approximation of the increase in revenue that would result from the elimination of all tax expenditures, and we use it in this report for that purpose. See Leonard Burman, Eric Toder & Christopher Geissler, *How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them?* Discussion Paper 31, Amer. Soc. Sci. Assoc'n (New Orleans, La., Jan. 5, 2008) 3, at [http://taxpolicycenter.org/UploadedPDF/1001234\\_tax\\_expenditures.pdf](http://taxpolicycenter.org/UploadedPDF/1001234_tax_expenditures.pdf); shorter version published in 98 *Amer. Econ. Rev.* 79 (2008) (stating that despite interaction effects, “commentators have added up tax expenditures to make general statements about their magnitude”).

<sup>6</sup> See Office of Management and Budget, Budget of the United States Government, Fiscal Year 2013, Supplemental Materials, Tax Expenditures Spreadsheet, Table 17-2, at <http://www.whitehouse.gov/omb/budget/Supplemental>.

at whatever level is required to raise the amount of revenue that Congress determines is appropriate.

## ANALYSIS OF PROBLEM

The National Taxpayer Advocate on numerous occasions has identified the complexity of the tax code as the most serious problem facing taxpayers and urged Congress to simplify it. In this section, we quantify the burden the tax code imposes, summarize the largest tax expenditures to make clear that fundamental tax reform will require difficult tradeoffs, share select comments on tax reform from taxpayers, make the case for a “zero-based budgeting” approach, summarize our office’s prior tax simplification recommendations in key areas, and propose several recommendations for Congressional consideration.

### A. Why is Tax Reform Needed?

#### 1. The Current Tax Code Imposes Huge Compliance Burdens on Individual Taxpayers and Businesses.

Consider the following:

- According to a TAS analysis of IRS data, individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code.<sup>7</sup> And that figure does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the “tax industry” requires the equivalent of more than three million full-time workers.<sup>8</sup>
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics data on the hourly cost of an employee, TAS estimates that the costs of complying with the individual and corporate

<sup>7</sup> The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2010 by the average amount of time the IRS estimated it took to complete the form. While the IRS’s estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation.

<sup>8</sup> This calculation assumes each employee works 2,000 hours per year (*i.e.*, 50 weeks, with two weeks off for vacation, at 40 hours per week).

income tax requirements for 2010 amounted to \$168 billion — or a staggering 15 percent of aggregate income tax receipts.<sup>9</sup>

- According to a tally compiled by a leading publisher of tax information, there have been approximately 4,680 changes to the tax code since 2001, an average of more than one a day.<sup>10</sup>
- The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted using the “word count” feature in Microsoft Word turned up nearly four million words.<sup>11</sup>
- Individual taxpayers find return preparation so overwhelming that about 59 percent now pay preparers to do it for them.<sup>12</sup> Among unincorporated business taxpayers, the figure rises to about 71 percent.<sup>13</sup> An additional 30 percent of individual taxpayers use tax software to help them prepare their returns,<sup>14</sup> with leading software packages costing \$50 or more. For 2007, IRS researchers estimated that the monetary compliance burden of the median individual taxpayer (as measured by income) was \$258.<sup>15</sup>

<sup>9</sup> The IRS and several outside analysts have attempted to quantify the costs of tax compliance. For an overview of previous studies, see Government Accountability Office, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the tax code. TAS estimated the cost of complying with personal and business income tax requirements (and thus excluding the time spent complying with employment, estate and gift, excise, and exempt organization tax requirements) by multiplying the total number of such hours (5.648 billion) by the average hourly cost of a civilian employee (\$29.72), as reported by the Bureau of Labor Statistics. See Bureau of Labor Statistics, U.S. Department of Labor, *Employer Costs for Employee Compensation — December 2010*, USDL: 11-0304 (Mar. 9, 2011) (including wages and benefits), at [http://www.bls.gov/news.release/archives/ecec\\_03092011.pdf](http://www.bls.gov/news.release/archives/ecec_03092011.pdf). TAS estimated compliance costs as a percentage of total income tax receipts for 2010 by dividing the income tax compliance cost as computed above (\$168 billion) by total 2010 income tax receipts (\$1.09 trillion). See Office of Management and Budget, *Budget of the United States Government - Fiscal Year 2013*, Historical Tables, Table 2-1, at <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/hist.pdf>. TAS's estimate that compliance costs amount to about 15 percent of aggregate income tax receipts falls within the range of some previous estimates. For example, Professor Joel Slemrod computed that compliance costs constitute about 13 percent of receipts, while the Tax Foundation computed that compliance costs constitute about 22 percent of income tax receipts. See Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business); Scott Moody, Wendy P. Warcholik & Scott A. Hodge, *Special Report: The Rising Cost of Complying with the Federal Income Tax* (Tax Foundation, Dec. 2005), at <http://www.taxfoundation.org/research/show/1281.html>.

<sup>10</sup> Unpublished Commerce Clearing House (CCH) data provided to TAS (Dec. 12, 2012). This count does not include changes made after Dec. 28, 2012, if any, as they would have been enacted after our publishing deadline. CCH advised us that its count of tax-law changes is somewhat understated, because multiple changes to a section might be grouped together and counted as a single entry on its finding lists of tax-law changes.

<sup>11</sup> To determine the number of words in the Internal Revenue Code, TAS downloaded a zipped file of Title 26 of the U.S. Code (*i.e.*, the Internal Revenue Code) from the website of the U.S. House of Representatives at [http://uscode.house.gov/download/title\\_26.shtml](http://uscode.house.gov/download/title_26.shtml). We unzipped the file, copied it into Microsoft Word, and used the “word count” feature to compute the number of words. The version of Title 26 we used was dated Jan. 3, 2012, so the count does not reflect legislation enacted during the second session of the 112th Congress. In Word, the document ran 9,191 single-spaced pages. The printed code contains certain information that does not have the effect of law, such as a description of amendments that have been adopted, effective dates, cross references, and captions. The word count feature also counts page numbers, the table of contents, and the like. Therefore, our count somewhat overstates the number of words that are officially considered a part of the tax code, although as a practical matter, a person seeking to determine the law will likely have to read and consider many of these additional words, including effective dates, cross references, and captions. Other attempts to determine the length of the Code may have excluded some or all of these components, but there is no clearly correct methodology to use, and we found no easy way to selectively delete information from a document of this length.

<sup>12</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2010).

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity 26* (presented at IRS Research Conference, June 2010).

## 2. Complexity Obscures Understanding and Creates a Sense of Distance Between Taxpayers and the Government, Resulting in Lower Rates of Voluntary Tax Compliance.

IRS data show that when taxpayers have a choice about reporting their income, tax compliance rates are remarkably low. Workers who are classified as employees have little opportunity to underreport their earned income because it is subject to tax withholding. Employees thus report about 99 percent of their earned income. But among workers whose income is not subject to tax withholding, compliance rates plummet. An IRS study found that nonfarm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.<sup>16</sup>

Noncompliance cheats honest taxpayers, who indirectly pay more to make up the difference. According to the IRS's most recent comprehensive estimate, the net tax gap stood at \$385 billion in 2006,<sup>17</sup> when there were 116 million households in the United States.<sup>18</sup> This means that each household was effectively paying a "surtax" of some \$3,300 to subsidize noncompliance by others.

This raises an important question: Why is it that few Americans would steal from their neighbor or a local charity, yet a high percentage of taxpayers who have a choice about paying taxes appear to have no compunctions about cheating their fellow citizens?

The Taxpayer Advocate Service has conducted some research into the causes of noncompliance, including a major study published in volume 2 of this report,<sup>19</sup> and plans to conduct additional studies. While we do not have definitive answers, we can suggest at least two hypotheses.

- First, no one wants to feel like a "tax chump" — paying more while suspecting that others are taking advantage of loopholes to pay less. In a TAS survey of taxpayers conducted this year, 73 percent said "[t]he wealthy have ways of minimizing their Federal taxes that are not available to the average taxpayer" and only 12 percent said, "everyone

<sup>16</sup> See IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006), at <http://www.irs.gov/uac/IRS-Updates-Tax-Gap-Estimates> (accompanying charts at [http://www.irs.gov/pub/irs-news/tax\\_gap\\_figures.pdf](http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf)). As low as these rates are, they would be even lower if not for the fact that some of this income is reported to the IRS by third parties. In January 2012, the IRS updated its estimate of the tax gap, but the updated study does not contain a breakout of compliance rates for sole proprietors or unincorporated farming businesses. Thus, the compliance rates cited in the text remain the most recent estimates available.

<sup>17</sup> See IRS News Release, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged From Previous Study*, IR-2012-4 (Jan. 6, 2012), at <http://www.irs.gov/uac/IRS-Releases-New-Tax-Gap-Estimates;-Compliance-Rates-Remain-Statistically-Unchanged-From-Previous-Study>. The "net" tax gap reflects the amount by which tax liabilities exceed tax collection after accounting for late payments and enforced collections. The "gross" tax gap — the amount of tax due but not paid timely and before enforced collections — was estimated to be \$450 billion.

<sup>18</sup> U.S. Census Bureau, Table H-1, *Income Limits for Each Fifth and Top 5 Percent of All Householders: 1967 to 2011*, at <http://www.census.gov/hhes/www/income/data/historical/household/index.html>.

<sup>19</sup> See Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, vol. 2, *infra*.

pays their fair share of taxes.”<sup>20</sup> Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in “fudging” to right the perceived wrong. Transparency is a critical feature of a successful tax system and is essential if the system is to build taxpayer confidence and maintain high rates of tax compliance. Simplifying the tax code so tax policy choices and computations are more transparent would go a long way toward reassuring taxpayers that the system is not rigged against them.

- Second, most people feel a sense of affinity and unity with local organizations, while in relative terms, they feel disconnected from the federal government. This may be because members of a community generally understand the services that local organizations provide and the benefits they personally derive, while many Americans do not understand how their tax dollars are spent or how they benefit. It may also be because they know the leaders of local community groups personally, while the federal government is faceless. Either way, stealing from a local charity may feel to many like stealing from family and friends, while cheating on one’s taxes feels more like a victimless offense.<sup>21</sup>

For these reasons, we believe it is important to increase taxpayer awareness of the connection between taxes paid and benefits received. We have recommended that Congress direct the IRS to provide all taxpayers with a “taxpayer receipt” showing how their tax dollars are being spent.<sup>22</sup> This “taxpayer receipt” could be a more detailed version of the pie chart currently published by the IRS,<sup>23</sup> but it should be provided directly to each taxpayer in connection with the filing of a tax return.<sup>24</sup> Better public awareness of the connection between taxes and government spending has the potential to improve civic morale, increase tax compliance, and make the national dialogue over looming fiscal policy choices more productive as well.

<sup>20</sup> Russell Research, Inc., *Factors Influencing Compliance: Topline Summary* (May 2012). Russell Research conducted this survey for TAS among a statistically representative sample of sole proprietors. A detailed presentation and analysis of the survey results is published in Volume 2 of this report. See Research Study: *Factors Influencing Voluntary Compliance by Small Businesses: Preliminary Survey Results*, vol. 2, *infra*.

<sup>21</sup> See generally National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 147-150 (Research Study: *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*) (discussing the effect of social norms on tax compliance).

<sup>22</sup> See National Taxpayer Advocate 2010 Annual Report to Congress 368 (Legislative Recommendation: *Enact Tax Reform Now*).

<sup>23</sup> IRC § 7523 requires the IRS to include pie-shaped graphs showing the relative sizes of major outlay categories and major income categories in its instructions for Forms 1040, 1040A, and 1040EZ; see IRS Form 1040 Instructions (2011), at 97.

<sup>24</sup> In April 2011, the White House website launched a calculator titled “Your Federal Taxpayer Receipt” that allows taxpayers to enter the actual or estimated amounts of their Social Security, Medicare, and income tax payments and to see a breakdown showing how their payments are being applied to major categories of federal spending, including Social Security, Medicare, national defense, health care, job and family security programs, interest on the national debt, Veterans benefits, and education. While we view the availability of this calculator as a positive development, most taxpayers will not take the time to visit this website. We therefore believe a taxpayer receipt should be provided in connection with the filing of a return.

### 3. The Tax Code Is So Complex That the IRS Has Difficulty Administering It.

The IRS employs some 90,000 full-time workers<sup>25</sup> and performs many of its tasks very well, but it faces daunting challenges in administering the tax code. This report catalogs many of them. Two key indicators of taxpayer service are the IRS's ability to answer taxpayer telephone calls and the IRS's ability to respond to taxpayer correspondence. Despite the fact that about 90 percent of individual taxpayers rely on preparers or tax software packages, the IRS received more than 115 million calls in each of the last two fiscal years.<sup>26</sup> That is a staggering volume of calls, and not surprisingly, the IRS has had trouble answering them. In fact, the problem is growing worse. From FY 2004 to FY 2012, the number of calls the IRS received from taxpayers on its Accounts Management phone lines increased from 71 million to 108 million, yet the number of calls answered by telephone assistors declined from 36 million to 31 million.<sup>27</sup> The IRS has increased its ability to handle taxpayer calls using automation, but even so, the percentage of calls from taxpayers seeking to speak with a telephone assistor that the IRS answered dropped from 87 percent to 68 percent over the period.<sup>28</sup> And among the callers who got through, the average time they spent waiting on hold increased from just over 2½ minutes in FY 2004 to nearly 17 minutes in FY 2012.<sup>29</sup>

Over the same FY 2004 through FY 2012 period, the IRS's ability to timely process taxpayer correspondence also declined. The IRS receives more than ten million letters from taxpayers each year responding to IRS adjustment notices.<sup>30</sup> Comparing the final week of FY 2004 with the final week of FY 2012, the backlog of taxpayer correspondence in the tax adjustments inventory increased by 188 percent (from 357,151 to 1,028,539 pieces), and the percentage of taxpayer correspondence classified as "overage" jumped by 316 percent (from 11.5 percent to 47.8 percent).<sup>31</sup>

As discussed throughout this report, the IRS also struggles to enforce the tax laws, and often burdens taxpayers unnecessarily in attempting to do so.

<sup>25</sup> According to the 2011 IRS Data Book, the IRS ended FY 2011 with about 91,380 full-time equivalent employees — about 3,000 fewer employees than at the end of FY 2010. IRS Data Book, 2011, Table 30, at <http://www.irs.gov/pub/irs-soi/11databk.pdf>. In FY 2012, the IRS budget was reduced by 2.5 percent, which has led to a further reduction in the number of employees. See Department of the Treasury, FY 2013 Budget in Brief, at [http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS\\_508%20-%20passed.pdf](http://www.treasury.gov/about/budget-performance/budget-in-brief/Documents/11.%20IRS_508%20-%20passed.pdf) (showing a decline in enacted appropriations levels from FY 2011 to FY 2012).

<sup>26</sup> IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2011 and Sept. 30, 2012).

<sup>27</sup> Compare IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2012) with IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2004). The Accounts Management phones lines (previously known as the Customer Account Services phone lines) receive the significant majority of taxpayer calls. However, taxpayer calls to compliance phone lines and certain other categories of calls are excluded from this total.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* See Most Serious Problem: *The IRS Must Confront Challenges to Delivering Quality Taxpayer Service in the Twenty-First Century*, *infra*.

<sup>30</sup> See, e.g., IRS, Joint Operations Center, *CAS Accounts Management Paper Inventory Reports: FY12 July-September Fiscal Year Comparison*.

<sup>31</sup> Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 29, 2012) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004).

Simply put, tax code complexity strains the IRS's ability to serve taxpayers, while a simpler code would make the job of the tax administrator much easier – something that would benefit taxpayers and the government alike.

### **B. Tax Simplification Requires Trade-Offs.**

There is a widespread belief that the influence of “special interests” is the biggest roadblock to comprehensive tax reform. There is no doubt that many provisions in the tax code benefit narrow groups of taxpayers. But the largest special interests are us — the vast majority of U.S. taxpayers. Virtually all of us benefit from tax breaks that are technically defined as “tax expenditures” — special reductions in tax revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.<sup>32</sup>

As a preliminary note, we use the term “tax expenditure” rather than “tax loophole” because, in our view, the term “loophole” has taken on a meaning that distorts discussion. In general, taxpayers and policymakers use the term “loophole” to describe a tax expenditure that they do not agree with (or do not benefit from) and use terms like “incentives” or “sound government policy” to describe tax expenditures that they like. To promote a constructive dialogue, we should keep in mind that every provision in the tax code had enough support to pass the House and Senate and be signed into law by the President, and while some provisions benefit broader taxpayer segments than others, every tax break has a constituency. One taxpayer's loophole may be another taxpayer's lifeline, and vice versa. Notably, the significant majority of tax expenditures benefits the masses.

For FY 2013, the Joint Committee on Taxation has estimated that total individual income tax expenditures will come to \$1.09 trillion,<sup>33</sup> and the Treasury Department has estimated the total as \$1.02 trillion.<sup>34</sup> The following tax expenditures account for 80 percent of this total:<sup>35</sup>

- The exclusion of employer contributions for medical insurance premiums and medical care (\$180.6 billion).

<sup>32</sup> Congressional Budget and Impoundment Control Act, Pub. L. No. 93-344, § 3(3) (1974). When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. As a practical matter, a tax expenditure has the same impact as a government spending program. To illustrate, assume that an individual facing a 25 percent tax rate pays \$10,000 in mortgage interest and that the government wants to provide a subsidy for home ownership. It could accomplish this objective in two ways: (1) it could allow the taxpayer to deduct the \$10,000 of mortgage interest from his gross income, which would produce a tax reduction of \$2,500, or (2) it could make a direct payment of \$2,500 to the taxpayer in lieu of the tax deduction. The taxpayer ends up in the same economic position either way. For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

<sup>33</sup> Staff of the Joint Committee on Taxation, 112th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015* (Joint Comm. Print 2012), at <https://www.jct.gov/publications.html?func=select&id=5>

<sup>34</sup> Office of Management and Budget, Budget of the United States Government, Fiscal Year 2013, Supplemental Materials, Tax Expenditures Spreadsheet, Table 17-2, at <http://www.whitehouse.gov/omb/budget/Supplemental>.

<sup>35</sup> This list reflects the Treasury Department's estimates. The Joint Committee on Taxation also publishes a list of tax expenditures. While the aggregate totals are similar, some estimates of specific tax expenditures vary considerably due to differences in methodology.

- The exclusion for retirement plan contributions and earnings (\$165.4 billion).<sup>36</sup>
- The mortgage interest deduction for owner-occupied housing (\$100.9 billion).
- The reduced rates of tax on long-term capital gains and qualified dividends (\$83.9 billion).<sup>37</sup>
- The deduction for nonbusiness state and local taxes (\$68.6 billion).
- The exclusion of net imputed rental income (\$51.1 billion).
- The deduction for charitable contributions (\$46.3 billion).
- The exclusion of Social Security and veterans' benefits (\$44.9 billion).<sup>38</sup>
- The exclusion of interest on state and local government bonds (\$25.7 billion).
- The exclusion of capital gains at death (\$23.9 billion).
- The exclusion of interest on life insurance savings (\$22.5 billion).

Other popular benefits include college education tax incentives, notably the exclusion for distributions from Section 529 education savings plans; income exclusions for armed forces personnel; the deduction for medical expenses; child and dependent care credits; tax-favored employee benefits; and the deduction for contributions to Flexible Spending Accounts (both medical and dependent care).

Another perspective: As noted above, the Treasury Department estimates that individual income tax expenditures will total about \$1.02 trillion in 2013.<sup>39</sup> As compared with about 140 million individual tax returns,<sup>40</sup> that amounts to an average reduction in tax of more than \$7,000 per return.

Because tax is computed as a percentage of income, the total amount of exclusions or deductions that would generate a \$7,000 tax reduction is a multiple of the tax reduction. Assume for purposes of illustration that a taxpayer pays a flat tax rate of 25 percent and does not qualify for any tax credits. At a 25-percent tax rate, the average tax reduction of \$7,000 would translate to deductions or exclusions from income worth \$28,000.

<sup>36</sup> This total represents the sum of Section 401(k)-type plans (\$72.7 billion), employer plans (\$52.3 billion), Individual Retirement Accounts (\$19.7 billion), self-employed plans (sometimes known as "Keogh" plans) (\$19.6 billion), and the low and moderate income savers credit (\$1.1 billion).

<sup>37</sup> Of this amount, \$62.0 billion is attributable to the reduced rates of tax on capital gains and \$21.9 billion is attributable to the reduced rates of tax on qualified dividends.

<sup>38</sup> Of this amount, \$37.7 billion is attributable to the exclusion of Social Security benefits from income and \$7.2 billion is attributable to the exclusion of veterans' benefits from income.

<sup>39</sup> See Office of Management and Budget, Budget of the United States Government, Fiscal Year 2013, Supplemental Materials, Tax Expenditures Spreadsheet, Table 17-2, at <http://www.whitehouse.gov/omb/budget/Supplemental>.

<sup>40</sup> The number of individual income tax returns filed was about 141 million in FY 2010 and about 144 million in FY 2011. See IRS Data Book, 2011, Table 2, at <http://www.irs.gov/pub/irs-soi/11datbk.pdf>. Complete data for FY 2012 was not available at press time.

**Example:**

In 2012, a married couple filing a joint federal income tax return received income and benefits totaling \$110,000. This included \$12,000 of excludible employer-provided health insurance and retirement plan contributions and \$16,000 of deductible payments for mortgage interest, state and local taxes, and charitable contributions. (These exclusions and deductions totaled \$28,000, which translates to \$7,000 in tax expenditures at a 25 percent rate of tax.) The couple received the benefit of two personal exemptions totaling \$7,600.<sup>41</sup> Therefore, the couple reduced their \$110,000 starting total by \$35,600 to arrive at a taxable income of \$74,400. Under the 2012 rate tables, the taxpayers end up with a federal tax liability of \$10,666. So even though this couple falls into the 25-percent marginal tax rate bracket, they end up paying an average tax rate of less than 10 percent of their aggregate income and excluded benefits.<sup>42</sup>

The list of popular tax expenditures presented above and scenarios such as this one make clear that tax reform is not an easy issue. In concept, most of us agree that the tax code is too complex and that broadening the tax base by eliminating existing tax breaks in exchange for lower rates would improve the system.<sup>43</sup> In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing tax breaks raises immediate concerns. And the lower we want tax rates to be, the more of these tax breaks we have to be willing to give up.

Despite these concerns, the National Taxpayer Advocate believes that fundamental tax reform is essential and urgent. We believe that taxpayers will support tax reform by wide margins if they better understand the trade-offs involved and can be part of an informed dialogue. If tax reform is enacted on a revenue-neutral basis, the average taxpayer's bill will not go up, and taxpayers will be much happier to have a simpler and more transparent system.<sup>44</sup> They will understand how much tax they are paying, they will understand how their tax is computed, and many will save time and money because they no longer will have to pay fees to a preparer to do the job for them.

<sup>41</sup> Personal exemptions and the standard deduction are not considered to be tax expenditures because they "defin[e] the zero-rate bracket that is a part of normal tax law." See Staff of the Joint Committee on Taxation, 112th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2011-2015*, at 5 (Joint Comm. Print 2012). However, they have the effect of reducing taxable income further. If the value of personal exemptions and the standard deduction were considered to be tax expenditures, the Treasury Department's and Joint Committee on Taxation's annual estimates of tax expenditures would be considerably larger.

<sup>42</sup> Because tax rates rise with income, these taxpayers pay tax at 10 percent on their first \$17,400 of taxable income, at 15 percent on taxable income between \$17,400 and \$70,700, and at 25 percent on their additional taxable income (under the tax rate tables for 2012).

<sup>43</sup> The bipartisan fiscal commission appointed by President Obama in 2010 made recommendations along these lines. See National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 15, 28-34 (Dec. 2010) at <http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform>.

<sup>44</sup> In the current environment, we understand that Congress may decide to raise revenue in the course of reforming the tax code rather than keep the system revenue-neutral. However, if the choice is between raising a given amount of revenue through increasing tax rates or eliminating tax expenditures, the same structural considerations apply. As discussed in the text above, we advocate tax simplification for the purpose of reducing taxpayer burden. We take no position regarding the broader economic effects of raising or lowering marginal tax rates.

It is important, however, to lay the groundwork for tax reform. Whenever proposals to reduce tax expenditures are made, affected groups and industries often mobilize quickly and seek to build public opposition. Therefore, the taxpaying public must understand that tax reform requires trade-offs between tax rates and tax breaks. An uninformed taxpayer who hears he may lose a tax break will instinctively want to keep it to prevent his tax bill from rising. An informed taxpayer often will have a very different reaction because she understands she will be losing a tax break but probably will not pay more (or at least not much more) because rates will be lowered.<sup>45</sup> The Tax Reform Act of 1986 was the last major revision of the tax code, and despite considerable initial concerns, taxpayers and Members of Congress came around. On the final votes, the Act was supported by significant bipartisan majorities in the House and the Senate.<sup>46</sup>

### **C. TAS Has Been Receiving Taxpayer Suggestions Through Its Tax Reform Web Page.**

To help promote a public dialogue about tax reform, the Office of the Taxpayer Advocate established a web page in January 2011 at [www.taxpayeradvocate.irs.gov](http://www.taxpayeradvocate.irs.gov) to solicit taxpayer suggestions. We promised to track and post comments periodically. We asked taxpayers to offer their thoughts on tax reform generally and to consider which tax breaks they would be willing to give up in exchange for simplification of the tax code. To date, we have received more than 3,000 comments. While the comments present a wide range of perspectives and address a variety of issues, most taxpayers seem to understand and support the need for trade-offs.

Here is a sampling of some of the comments:

“Get rid of all deductions, all special tax rates, all credits, and all special breaks . . . . The process should be so simple no one needs a tax preparer. I am a tax preparer and benefit from the current system, but it is still BAD BAD BAD for the country. It is a massive burden on the economy! I dare you to take away my livelihood! PLEASE!”

“. . . In order to get a lower tax rate, I would be willing to give up all my itemized deductions and take a standard deduction. Also, I would be willing to give up all my education and 401K and IRA tax breaks if they were included in one overall credit of some lesser amount. For wage earners like myself, you should be able to withhold the right amount of tax so that no return is necessary.”

<sup>45</sup> In the current environment, we understand that Congress may decide to raise revenue in the course of reforming the tax code rather than keep the system revenue-neutral. However, if the choice is between raising a given amount of revenue through increasing tax rates or eliminating tax expenditures, the same structural considerations apply. As discussed in the text above, we advocate tax simplification for the purpose of reducing taxpayer burden. We take no position regarding the broader economic effects of raising or lowering marginal tax rates.

<sup>46</sup> The vote to approve the conference report was 292-136 in the House and 74-23 in the Senate. See Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 at 4 (1987).

“I think we need a very simple flat tax that is collected at the source of all income. Eliminate deductions, credits, tax forms, everything. Make a flat percent for all salary income, perhaps a slightly higher percent for interest and dividends and then have it collected directly off of a person’s payroll or from the earnings source. This would eliminate the need for record keeping, tax returns, and loopholes. . . .”

“To reduce complexity, eliminate the Alternative Minimum Tax. The goal of the AMT was to prevent wealthy individuals from escaping paying income taxes by using deductions, credits, exclusions, and lower capital gains rates and/or loss offsets to significantly reduce or eliminate their income taxes. This same goal is achievable by either eliminating or phasing out those deductions, exclusions, etc. for the highest income levels. Depending upon the policy goal (for example, revenue neutrality or increased revenue), the highest rates could be lowered or remain the same. . . .”

“My idea of reform is simplicity. To me the fairest tax is a flat tax on gross income. Relative to individual returns, a graduated scale should be employed. Low income, middle class, high net worth individuals. Likewise with business and corporations.”

“I would be willing to give up any of the tax breaks that are offered in exchange for a simpler tax code that minimizes the amount of tax paid while still fulfilling the government obligations. If my taxes were to go down in roughly the same amount as the value of my current tax breaks I would not have a problem. . . .”

“Eliminate all ‘phase out’ provisions. For instance, phase out of [sic] the benefit of itemized deductions, Roth IRA deductions, taxation of Social Security, and (in many years) personal exemptions. All those ‘phase out’ calculations make understanding the tax process nearly impossible.”

“Simplify, simplify, simplify. I’m not necessarily saying flat rate for everybody but eliminate most deductions (both private and corporate) and just lower the tax rate(s). If I pay 15 percent initially but through deductions I only pay 10 percent, why not reduce my rate to say 11 percent? (I support deductions for dependents and charitable giving). The tax code is entirely too complicated, which has spawned a huge community of accountants, tax attorneys, and the IRS.”

“I would be willing to give up all credits and reimbursements for a clear, straightforward tax system with lower rates. . . . Taxes reflect a basic conflict between two concepts: 1) A democratic nation is a collective enterprise, and we should all help each other [and] 2) I shouldn’t have to pay for some total stranger’s benefit. I think that people in general are leaning towards #2 right now. While all tax expenditures have their logic, they often have larger consequences. The mortgage interest deduction doesn’t just encourage home ownership; it also encourages purchase of bigger homes. The capital gains rate doesn’t just encourage investment, it also encourages speculation. Student loan guarantees don’t just encourage access to higher educa-

tion; they also encourage proliferation of for-profit trade schools and pressure to raise tuition at public schools. . . .”

“Policy should be to not use tax codes for social and personal interest policy. It should collect reasonable taxes. My quick suggestions are two that will cost many people including myself: [1] Eliminate open-ended personal deductions. For example, health insurance premiums may be deducted to an arbitrary and not adjusted amount (for example, \$12,000 per year) to encourage but not fully compensate all and any health plans [and] [2] Home mortgage deduction – interest deduction should be capped at not more than \$10,000 per year. This encourages home ownership without endlessly rewarding home-related borrowing. . . .”

“I would give up all deductions for a simple rate system for taxes that does not entail anything more than a computer and an online form to complete and e file.”

The National Taxpayer Advocate does not necessarily endorse these suggestions, but we have included this selection to provide a sense of what we are hearing from the taxpaying public.<sup>47</sup> At least among members of the public who have taken the time to offer comments, support for tax simplification is strong.

#### **D. Zero-Based Budgeting Approach Could Assist Congress in Deciding Which Tax Breaks and IRS-Administered Social Programs to Retain and Which to Eliminate.**

As discussed above, we are well aware that tax reform has become part of the ongoing discussion about ways to reduce the federal budget deficit. However, our longstanding advocacy for fundamental tax reform is aimed at reducing taxpayer burden by simplifying tax compliance and making compliance requirements transparent to taxpayers. For that reason, we recommend that Congress approach tax reform in a manner similar to zero-based budgeting. Under that approach, the starting point would be a tax code without any exclusions or reductions in income or tax. As discussions proceed, tax breaks and IRS-administered social programs would be added only if lawmakers decide on balance that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS. Some tax provisions and programs will meet this test, while others will not. Factors to consider in making this assessment include whether the government continues to place a priority on encouraging the activity for which the tax incentive is provided, whether the incentive is accomplishing its intended purpose, and whether a tax expenditure is more effective than a direct expenditure for achieving that purpose.<sup>48</sup> At the end of the process, most taxpayers should be able to complete their returns without the need for a tax preparer, and taxpayers should be able to see clearly how their tax liabilities are derived.

<sup>47</sup> Additional comments are posted at [http://www.taxpayeradvocate.irs.gov/userfiles/file/Tax-Reform-Selected-Comments\(1\).pdf](http://www.taxpayeradvocate.irs.gov/userfiles/file/Tax-Reform-Selected-Comments(1).pdf).

<sup>48</sup> See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

The immediate elimination of certain tax benefits could cause hardships for individuals or businesses where established pricing or conduct is based on those provisions. For example, persons who own homes paid a purchase price that took into account the federal subsidy provided through the mortgage interest deduction. Sudden elimination of that deduction could cause the value of existing homes to drop substantially. If Congress decides to eliminate tax incentives in situations like this, transitional relief should be provided.

In our 2010 Annual Report to Congress, we recommended adoption of a process to evaluate whether a tax expenditure presents an administrative challenge to the IRS or taxpayers and the extent to which it achieves its intended purpose.<sup>49</sup> In our 2009 report, we proposed an analytic framework for evaluating whether specific social benefit programs — whether for individuals or for businesses — should be run through the tax system.<sup>50</sup>

If, in the context of structural tax reform, Congress applies this rigorous analytical framework to all proposed tax expenditures, it will incorporate solely those provisions that fulfill a compelling public policy purpose, that the IRS can effectively administer without undue burden to taxpayers, and that are designed to capture information to evaluate whether the benefit achieves its intended public policy outcome. Importantly, taxpayers and policymakers will understand why such provisions are included in the tax code and will be able to ascertain their effectiveness.

We are not so naïve as to suggest that all tax expenditures will be eliminated, even in the most robust tax reform effort. In fact, there are excellent public policy or administrative reasons for including some programs in the tax code — whether they benefit individuals, small businesses, or entire industries.<sup>51</sup> And we believe that given adequate lead time, proper design, and sufficient resources, the IRS can successfully administer many of these programs without unduly burdening taxpayers or itself.<sup>52</sup> But the tax system will run much

<sup>49</sup> See National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

<sup>50</sup> National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75-104 (*Running Social Programs Through the Tax System*). Among other factors, we suggested that Congress consider the IRS's existing relationship with and access to the targeted population as well as the additional burden imposed on that population, the IRS's ability to deliver the benefit in a timely manner and at the appropriate time, the IRS's access to information necessary to make eligibility determinations, and the IRS's suitability to be the administrator of the provision in light of its enforcement culture. We have also suggested that Congress consider whether the U.S. tax system should remain income-based or should add elements of a consumption tax. See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 35-73 (*An Analysis of Tax Administration Issues Raised by a Consumption Tax, Such as a National Sales Tax or Value Added Tax*). In this analysis, we outlined tax administration challenges that we encourage policymakers to consider if a detailed consumption tax proposal is ultimately developed.

<sup>51</sup> For example, the IRS in some cases already has access to all the financial or other data required to determine eligibility for a benefit. If another agency were tasked with administering the benefit, the beneficiary would be required to submit the information twice (once to the IRS and once to another agency) or the IRS would be directed to share confidential tax return information, which would impose administrative burden on two agencies and could undermine future tax compliance.

<sup>52</sup> In our 2010 Annual Report to Congress, we recommended that the IRS revise its mission statement to explicitly acknowledge and describe its dual mission of collecting taxes and delivering social benefits. We believe that recognition of the IRS's dual role will help ensure that the IRS is adequately funded to deliver all of its programs and cause it to shift its emphasis from primarily enforcement to providing better service and assistance to its taxpayers and beneficiaries as well. See National Taxpayer Advocate 2010 Annual Report to Congress 15-27 (*Most Serious Problem: The IRS Mission Statement Does Not Reflect the Agency's Increasing Responsibilities for Administering Social Benefits Programs*).

more smoothly if only tax benefits and social programs that withstand this analysis are included in the tax code.

#### **E. Prior National Taxpayer Advocate Recommendations to Simplify Portions of the Tax Code Should Be Considered.**

Over the past decade, the Office of the Taxpayer Advocate has made numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of structural tax reform in mind, they should be considered as part of an overall tax reform process.

**Repeal the Alternative Minimum Tax (AMT) for Individuals.**<sup>53</sup> Few people think of having children or living in a high-tax state as a tax-avoidance maneuver, but under the unique logic of the AMT, that is essentially how those actions are treated. The AMT effectively requires taxpayers to compute their taxes twice – once under the regular tax rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. Disallowance of the deductions for state and local taxes and for personal exemptions accounted for about 87 percent of all AMT revenue generated by preference items in 2008.<sup>54</sup> The AMT computations are also extremely burdensome. The National Taxpayer Advocate has recommended that the AMT be repealed. Moreover, we note that if tax expenditures are substantially reduced, the AMT would be rendered largely irrelevant.<sup>55</sup>

**Consolidate the Family Status Provisions.** Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004, the tax code’s family status provisions continue to ensnare taxpayers and make tax administration difficult simply because of the number of such provisions and their structural interaction. These provisions include filing status, personal and dependency exemptions, the child tax credit, the EITC, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements — such as support or maintenance costs

<sup>53</sup> The AMT is discussed in more detail later in this report. See Most Serious Problem: *The Alternative Minimum Tax Corrodes Both the Tax System and the Democratic Process*, *infra*.

<sup>54</sup> See Tax Policy Center, *AMT Preference Items 2002, 2004-2008* (Dec. 21, 2010), at <http://www.taxpolicycenter.org/taxfacts/displayafact.cfm?DocID=468&Topic2id=30&Topic3id=36>.

<sup>55</sup> The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony since 2001. See National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); see also *Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (March 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

of the home — are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives. The National Taxpayer Advocate has recommended that, as part of a comprehensive reform of the tax code's tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work.<sup>56</sup>

**Improve Other Provisions Relating to Taxation of the Family Unit.** The tax code currently imposes “joint and several liability” on married persons who file a joint federal income tax return. This concept dates back to the early years of the income tax when a husband was typically the sole wage earner for the family unit. Today, husbands and wives often have separate assets and incomes that they do not equally control. Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse's income, at least in cases where he or she does not know about the income of the other spouse and does not significantly benefit from it, Congress has enacted relief rules. However, these relief rules are complex, do not always produce the right result, and impose a large burden on the “innocent spouse” to prove his or her case. The National Taxpayer Advocate has recommended several steps to improve equity and simplify the rules, including eliminating joint and several liability for joint filers.<sup>57</sup>

The “kiddie tax” rules are another family-related area of taxation that create significant burden for some taxpayers. The tax code currently taxes a minor child's unearned income above a certain threshold at the parent's tax rate. The parent must decide whether to file a separate return for the child or include the child's income on the parent's own return. The calculations required to determine which option is preferable in a particular case are complex. Moreover, if the child's parents are separated, additional complications arise. If a custodial parent has been designated, the child's income must be included on that parent's return. If no custodial parent has been designated, the law requires the tax to be computed by reference to the return of the parent with the greater taxable income. During a divorce proceeding, however, spouses sometimes conceal their assets or income from the other spouse, making compliance with these rules impractical. The National Taxpayer Advocate has recommended that the unearned income of minor children above a specified threshold be taxed at a higher rate and that the link between the computation of the child's tax liability and the parent's tax return be severed.<sup>58</sup>

<sup>56</sup> See Legislative Recommendation: *Simplify the National Status and Related Requirements for Qualifying Children*, *infra*, and Legislative Recommendation: *Amend IRC § 7703(b) to Remove the Household Maintenance Requirement and to Permit Taxpayers Living Apart on the Last Day of the Tax Year Who Have Legally Binding Separation Agreements to Be Considered “Not Married,”* *infra*; see also National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

<sup>57</sup> See National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*); see also National Taxpayer Advocate 2001 Annual Report to Congress 128-165 (Legislative Recommendation: *Joint and Several Liability*).

<sup>58</sup> See National Taxpayer Advocate 2002 Annual Report to Congress 231-242 (Legislative Recommendation: *Children's Income*).

**Consolidate Education Savings Tax Incentives.** The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. However, taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. The National Taxpayer Advocate has recommended that Congress consolidate incentives and harmonize definitions and other terms to the extent possible.<sup>59</sup>

**Consolidate Retirement Savings Tax Incentives.** The tax code contains at least 16 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education savings incentives, the large number of retirement savings options and the lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate has recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement savings option for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.<sup>60</sup>

**Simplify Worker Classification Determinations to Minimize Employee-versus-Independent Contractor Disputes.** The complexity and ambiguities in the existing worker classification rules create uncertainty for businesses and workers and lead to noncompliance. In general, businesses are required to pay and withhold employment tax, withhold income tax, and provide benefits only with respect to employees. Consequently, businesses have an incentive to classify workers as independent contractors to reduce their costs. Some workers seeking to avoid their tax obligations may also prefer to be classified as contractors if the business does not withhold taxes or report the payments to the IRS. Whether a worker should be classified as an employee or an independent contractor depends on a variety of factors that reflect the nature of the relationship between the worker and the business. The National Taxpayer Advocate has recommended that Congress:

<sup>59</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 370-372 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).

<sup>60</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 373-374 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).

- 1) Replace § 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes, and require that the IRS consult with affected industries and report back to the tax-writing committees on the findings of its consultations, with the ultimate goal that the Secretary issue guidance based on these findings, including guidance with specific industry focus;<sup>61</sup>
- 2) Direct the IRS to develop an electronic tool to determine worker classifications that employers would be entitled to use and rely upon, absent misrepresentation;
- 3) Allow both employers and employees to request classification determinations and seek recourse in the United States Tax Court; and
- 4) Direct the IRS to conduct outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.<sup>62</sup>

**Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets.** The tax code contains more than 100 provisions that expired at the end of 2011 or were set to expire at end of the 2012,<sup>63</sup> up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years to reduce their cost for budget-scoring purposes. However, tax sunsets make it difficult for both the government and taxpayers to plan, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and may even reduce tax compliance. The National Taxpayer Advocate has suggested several ways for Congress to reduce or eliminate the procedural incentives to enact temporary tax provisions.<sup>64</sup>

**Eliminate (or Simplify) Phase-Outs.** Roughly half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer's income increases. There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. Moreover, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to estimate their tax liabilities and pay the correct amount of withholding or estimated taxes, possibly reducing tax compliance. Phase-outs also create marginal "rate bubbles" — income ranges within which an additional dollar of income earned by a relatively low income taxpayer is taxed at a higher rate than an additional dollar of income earned by a relatively

<sup>61</sup> Our initial recommendation was simply to require that the Secretary issue guidance. Based on subsequent discussions with small business groups, we revised our recommendation to suggest that Congress first direct the IRS to hold a series of consultations with affected industries and report back to the tax-writing committees on its findings.

<sup>62</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: *Worker Classification*).

<sup>63</sup> See Joint Committee on Taxation, *List of Expiring Federal Tax Provisions 2011-2022*, JCX-1-12 (Jan. 6, 2012), at <https://www.jct.gov/publications.html?func=startdown&id=4383>.

<sup>64</sup> See National Taxpayer Advocate 2008 Annual Report to Congress 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

high income taxpayer. Because Congress could achieve a similar distribution of the tax burden based on income level by adjusting marginal rates, phase-outs introduce unnecessary complexity to the Code. The National Taxpayer Advocate has recommended that Congress repeal phase-outs or at least reassess them individually to ensure that they are necessary to accomplish their intended objective.<sup>65</sup>

**Streamline the Penalty Regime.** The number of civil tax penalties has increased from about 14 in 1954 to more than 130 today. The last comprehensive reform of the tax code's penalty provisions was enacted in 1989, after careful study by Congress, the IRS, and others. Since then, legislative and administrative changes to the penalty regime have proceeded piecemeal, but without the kind of careful analysis conducted in 1989. The National Taxpayer Advocate has recommended that Congress direct the IRS to (1) collect and analyze more detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each penalty on voluntary compliance. Congress should appropriate additional funds for this research, as necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer Advocate has recommended 11 steps that could be taken immediately.<sup>66</sup>

#### **F. While Corporate Tax Reform Is Needed, Individual Income Tax Reform Should Be Given Priority.**

The tax reform recommendations in this report focus on the individual income tax regime. This is for two reasons. First, there are vastly more taxpayers who file individual income tax returns. Second, even among businesses, most conduct their operations as sole proprietors or through “pass-through” entities and ultimately report their business income on their individual income tax returns.

Specifically, there were over 140 million individual tax returns filed in FY 2011.<sup>67</sup> There were also more than 32 million pass-through businesses, including at least 22.3 million sole proprietors that filed Schedules C,<sup>68</sup> at least 1.9 million farmers that filed Schedules F,<sup>69</sup> 4.5 million S corporations that filed Forms 1120-S,<sup>70</sup> and 3.6 million partnerships that filed Forms 1065.<sup>71</sup> By contrast, only 2.3 million C corporations are taxed at the entity level and would derive most of the direct benefits of corporate tax reform.<sup>72</sup> This is not to minimize

<sup>65</sup> See *id.* at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*).

<sup>66</sup> See *id.* at 414-418 (Legislative Recommendation: *Reforming the Penalty Regime*), and vol. 2, Research Study: *A Framework for Reforming the Penalty Regime*.

<sup>67</sup> See IRS Data Book, 2011, Table 2, at <http://www.irs.gov/pub/irs-soi/11databk.pdf>.

<sup>68</sup> IRS Compliance Data Warehouse, Individual Returns Transaction File (Fiscal Year 2011). This figure reflects the number of Form 1040-series returns that contained at least one Schedule C. Some returns contained more than one Schedule C, so the total number of sole proprietorships was somewhat greater than 22.3 million.

<sup>69</sup> *Id.* This figure reflects the number of Form 1040-series returns that contained at least one Schedule F. Some returns contained more than one Schedule F, so the total number of unincorporated farming businesses was somewhat greater than 1.9 million.

<sup>70</sup> IRS Data Book, 2011, Table 2, at <http://www.irs.gov/pub/irs-soi/11databk.pdf>.

<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

the need for corporate tax reform, and the rationale for curtailing tax benefits in exchange for lower rates applies in that context as well. We are simply saying that corporate tax reform will not eliminate any of the complexity or burden that the vast majority of U.S. taxpayers experience today.

## CONCLUSION

For all the reasons described above, we believe that fundamental reform must be made a priority. A simpler, more transparent tax code will substantially reduce the estimated 6.1 billion hours and \$168 billion that taxpayers spend on return preparation; reduce the likelihood that sophisticated taxpayers can exploit arcane provisions to avoid paying their fair share of tax; enable taxpayers to understand how their tax liabilities are computed and prepare their own returns; improve taxpayer morale and tax compliance — including the level of connection that taxpayers feel with the government; and enable the IRS to administer the tax system more effectively and better meet taxpayer needs.

Based on all the comments we receive every year in the Taxpayer Advocate Service and our experience in handling hundreds of thousands of taxpayer cases a year, we believe that lowering rates in exchange for broadening the tax base would be an excellent bargain. We are confident that in the end, public support for a simpler code will be strong and deep.

## Recommendations

The National Taxpayer Advocate recommends that Members of Congress take the following steps:

1. Consider holding meetings with constituents to discuss both the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that tax reform will require. In our view, it is critical to lay this groundwork for tax reform to succeed. The evolution of the Tax Reform Act of 1986 suggests that taxpayers will initially be concerned about losing tax benefits but will ultimately support tax simplification if and when they feel confident that the loss of tax benefits will be substantially offset by a reduction in tax rates.
2. Employ a “zero-based budgeting” approach to comprehensive tax reform that starts out with the assumption that all tax benefits will be eliminated and adds tax benefits back only if Members conclude that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity that doing so creates for taxpayers and the IRS. We are concerned that if Members do not follow this approach, the final outcome will reflect more tinkering around the margins than fundamental tax simplification.
3. Consider some of the specific recommendations we have made in the past and summarized in this section — not as a substitute for comprehensive reform but as a checklist to ensure that these important issues are addressed.
4. Solicit suggestions and comments from the IRS regarding the administrability of tax reform provisions under consideration. Proposals that make theoretical sense must be practical for the IRS to translate into forms and instructions and must be enforceable.
5. Solicit suggestions and comments from the National Taxpayer Advocate regarding the taxpayer burden and taxpayer rights impact of tax reform provisions under consideration. Conceptually sound proposals should be tested to ensure they are comprehensible to taxpayers, easy to comply with, and administrable by the IRS without undue burden or harm to taxpayers.
6. Amend Section 7523 of the Internal Revenue Code to direct the IRS to provide each taxpayer with a “Taxpayer Receipt” in conjunction with the filing of a tax return that shows how the taxpayer’s tax payments will be spent. For the reasons discussed above, we believe public trust in Congress and the government will be enhanced if taxpayers see more clearly the connection between the taxes they pay and the benefits they receive.