MSP #9 COMPLEXITY: The IRS Does Not Report on Tax Complexity as Required by Law

RESPONSIBLE OFFICIALS

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DEFINITION OF PROBLEM

The IRS is required by law to report to Congress each year on the sources of complexity in tax administration and on ways to reduce it.[1] However, the IRS has issued only two such reports and none since 2002.[2] Congress adopted many of the recommendations in those reports. As the tax administrator, only the IRS has certain data about complexity, and its short reports probably helped both the IRS and Congress to identify and address key problem areas. Thus, the IRS's decision to discontinue the reports has likely contributed to tax complexity, which burdens taxpayers and the IRS alike. Conversely, revisiting this decision could help improve tax law clarity, administrability, and fairness. If the IRS did this, it would further the taxpayer *rights to be informed* (*e.g.*, to know and understand what they need to do to comply), *to quality service* (*e.g.*, to receive clear and easily understandable communications from the IRS), and *to a fair and just tax system*.[3]

ANALYSIS OF PROBLEM

Congress Requires the IRS to Analyze and Report on Complexity.

The Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98) requires the IRS to analyze and report on the sources of complexity in tax administration each year.[4] Specifically, RRA 98 § 4022(a) states:

> (1) In general.--The Commissioner of Internal Revenue shall conduct each year after 1998 an analysis of the sources of complexity in administration of the Federal tax laws. Such analysis may include an analysis of—
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> (A) questions frequently asked by taxpayers with respect to return filing;
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> (B) common errors made by taxpayers in filling out their returns;
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> (C) areas of law which frequently result in disagreements between taxpayers and the Internal Revenue Service;
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> (D) major areas of law in which there is no (or incomplete) published guidance or in which the law is uncertain;

1 *See* Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105–206, Title IV, § 4022(a), 112 Stat. 785 (1998) (codified at Internal Revenue Code (IRC) § 7801(note)).

2 IRS, Office of Research Analysis and Statistics, *Annual Report from the Commissioner of Internal Revenue on Tax Law Complexity*, Pub. 4105 (June 5, 2000) [hereinafter 2000 Complexity Report]; IRS, Office of Research Analysis and Statistics, *Annual Report from the Commissioner of Internal Revenue on Tax Law Complexity*, Pub. 4105 (Sept. 20, 2002) [hereinafter 2002 Complexity Report].

3 *See* IRS, Pub. 1, *Your Rights as a Taxpayer* (2014).

4 RRA 98 § 4022(a) (codified at IRC § 7801(note)).

(E) areas in which revenue officers make frequent errors interpreting or applying the law;[5]

(F) the impact of recent legislation on complexity; and

(G) forms supplied by the Internal Revenue Service, including the time it takes for taxpayers to complete and review forms, the number of taxpayers who use each form, and how recent legislation has affected the time it takes to complete and review forms.

(2) Report.--The Commissioner shall not later than March 1 of each year report the results of the analysis conducted under paragraph (1) for the preceding year to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate. The report shall include any recommendations—

(A) for reducing the complexity of the administration of Federal tax laws; and

(B) for repeal or modification of any provision the Commissioner believes adds undue and unnecessary complexity to the administration of the Federal tax laws.

The Joint Committee on Taxation (JCT) explained the reason for the provision as follows:

> The National Commission on Restructuring the IRS found a clear connection between the complexity of the Internal Revenue Code and the difficulty of tax law administration and taxpayer frustration. The Committee shares the concern that complexity is a serious problem with the Federal tax system. Complexity and frequent changes in the tax laws create burdens for both the IRS and taxpayers. Failure to address complexity may ultimately reduce voluntary compliance….
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> In some cases other policies, such as fairness, may outweigh concerns about complexity. Nevertheless, the Congress believed complexity of the tax system should be reduced whenever possible. Accordingly, the Congress believed … that the tax-writing committees should receive periodic input from the IRS regarding areas of the law that cause problems for taxpayers. This input will be valuable in developing future legislation.[6]

In other words, Congress required the IRS to prepare an annual complexity report to highlight administrative and legislative changes that could reduce complexity and taxpayer frustration, while improving voluntary tax compliance. In addition, Congress suggested that the report include data that would aid Congress in crafting future legislation, and also enable Congress to determine that taxpayer protections were being followed (*e.g.*, by reporting where revenue officers make frequent errors).

The tax code is so complicated that it is probably difficult for most members of Congress to know how to simplify it without large-scale tax reform. However, large-scale tax reform does not happen very often. In the meantime, Congress might be able to make steady progress toward simplification if it had a data-driven road map to highlight the areas of complexity that are causing the most problems for taxpayers and the IRS. The IRS is uniquely positioned to provide Congress with that map, which is what it is required to do under RRA 98 § 4022(a).

5 The IRS's complexity reports identified the areas of the tax code where revenue agents (not revenue officers) made frequent errors, but the IRS no longer tracks tax law errors by code section. IRS response to TAS information request (June 5, 2014); IRS response to TAS fact check (Oct. 30, 2014) (clarifying the IRS could identify the code sections that were the source of frequent errors by reviewing a sample of cases where employees were deemed to have made tax law errors). In general, a revenue agent audits returns, whereas a revenue officer collects tax assessments.

6 Joint Committee on Taxation (JCT), JCS-6–98, *General Explanation of Tax Legislation Enacted in 1998*, 142–143 (Nov. 24, 1998).

Tax Complexity Remains a Costly and Burdensome Problem for the IRS and Taxpayers Alike.

The complexity of the tax code, which has reached nearly four million words, continues to burden taxpayers and drain IRS resources.[7] According to a tally compiled by a leading publisher of tax information, there have been approximately 4,107 changes to the tax code since 2004, an average of more than one a day.[8] The number of IRC sections, subsections and cross-references increased by 46 percent (from 45,789 to 66,812) between 1991 and 2012.[9] Individual taxpayers find return preparation so overwhelming that about 94 percent of them used a preparer or tax software in processing year (PY) 2013.[10]

Internal Revenue Code growth, 1991-2012

While preparers' fees vary widely, leading software packages often cost $50 or more.[11] For 2007, IRS researchers estimated the monetary compliance burden of the median individual taxpayer (as measured by income) was $258.[12]

It is difficult to quantify the additional costs to the government of increasing complexity. However, tax expenditures—rules that contribute to complexity by providing special tax benefits to certain taxpayers—are estimated at about $1.4 trillion for fiscal year (FY) 2015.[13] Tax expenditures also increase IRS operating costs. As one example, for FY 2015 the Treasury Department requested about $452 million for the IRS to administer the recently-enacted Affordable Care Act (ACA) program for one year.[14]

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7 *See* National Taxpayer Advocate 2012 Annual Report to Congress 3–23; National Taxpayer Advocate 2010 Annual Report to Congress 3–14; National Taxpayer Advocate 2008 Annual Report to Congress 3–14; *see also Hearing on Fundamental Tax Reform: Hearing Before the H. Comm. on Ways and Means*, 112th Cong. (2011) (statement of Nina E. Olson, National Taxpayer Advocate).

8 Email from Wolters Kluwer, Commerce Clearing House (CCH) to TAS (Sept. 29, 2014). This data does not include changes after September 29, 2014. 4,107 changes divided by 3,924 days (365 per year, plus four leap days, and 271 days in 2014) equals 1.05 changes per day.

9 Rosemary Marcuss *et. al.*, *Income Taxes and Compliance Costs: How are They Related?*, 66(4) N. Tax J. 833–54 (Dec. 2013).

10 IRS Compliance Data Warehouse, Individual Returns Transaction File (Oct. 23, 2014).

11 *See, e.g.*, TurboTax, https://turbotax.intuit.com/personal-taxes/compare.jsp (last visited Oct. 1, 2014) (listing paid software prices ranging from $39.99 to $99.99, with all but "basic" priced at or above $49.99).

12 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).

13 *See* Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government*, Fiscal Year 2015, Table 14–1, *at* http://www.whitehouse.gov/omb/budget/Analytical_Perspectives/. *See also* Staff of the JCT, 112th Cong., JCS-1–13, *Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017* (Feb. 1, 2013), *at* https://www.jct.gov/publications.html?func=select&id=5 (listing about $1.348 billion in tax expenditures).

14 U.S. Department of Treasury, IRS, *The Budget in Brief* 20 (FY 2015), http://www.irs.gov/uac/Strategic-Plan-and-Other-References.

While the IRS would need to spend some resources to produce the complexity report, these costs pale in comparison to the costs of complexity.

IRS employees also require more training to administer complex provisions. Moreover, tax complexity can create ambiguities that lead to tax shelters and a loss of confidence by the public in the fairness of the tax code. As a result, complexity can lead to a reduction in voluntary tax compliance and revenue.

While the IRS would need to spend some resources to produce the complexity report, these costs pale in comparison to the costs of complexity.[15] Moreover, if they prompt a reduction in tax complexity, the reports might ultimately help the IRS do its job and reduce the cost of administering the tax code.

According to the IRS, Reducing Complexity Furthers its Mission.

In its first complexity report, the IRS explained that complexity reduction furthers its mission, as follows:[16]

> Aside from the requirements of RRA 98, the Service believes complexity must be addressed to effectively reduce taxpayer burden and improve taxpayer compliance, two key components of the Service's mission. Reducing complexity can reduce taxpayer burden by reducing the time and costs taxpayers face in meeting their tax obligations and increase compliance by making those same obligations easier to understand and meet. Reducing complexity also will make it easier for Service employees to do their jobs of providing services to taxpayers and enforcing the law….
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> Reducing complexity is important to the success of the Service. The mission of the Service is to '[P]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all' …. Reducing complexity will aid the Service in achieving all of its strategic goals. By reducing burden, the IRS better serves each taxpayer. By increasing compliance, IRS better serves all taxpayers. In making the Code less complex, the working environment for IRS employees becomes more productive.[17]

In other words, if the complexity report helps reduce complexity, it also helps the IRS achieve its mission.

The IRS's Two Complexity Reports Helped Reduce Complexity, as Intended.

The process of drafting the complexity reports prompted the IRS to analyze all of the information suggested by Congress, and consult with stakeholders, such as tax preparation software vendors, practitioners,

15 In response to a request for an estimate of the resources the IRS would need to produce the complexity report, the IRS's Research, Analysis and Statistics (RAS) function stated that "as an order of magnitude" a paper that examined the relationship between tax complexity and income tax compliance required about two full time employees working for about a year. IRS response to TAS information request (June 20, 2014). It later clarified that it had no information about the resources required by other functions to assist or coordinate this work. IRS response to TAS information request (Oct. 27, 2014). It noted that the previous complexity reports required considerable data extraction and verification from IRS units, and the issue identification, development and recommendations in the previous reports required significant coordination and collaboration with Treasury's Office of Tax Analysis. IRS response to TAS information request (Oct. 30, 2014).

16 The IRS mission is to "[P]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all." Internal Revenue Manual 1.1.1.1, *The IRS Mission* (Mar. 1, 2006).

17 2000 Complexity Report at 4.

academics, and IRS employees who interact with taxpayers. This activity prompted policymakers within the IRS to make forms and instructions easier to understand.[18]

In addition, Congress ultimately adopted many of the reports' recommendations. In the 2000 complexity report, which was only 40 pages (excluding Appendix), the IRS provided options for reducing complexity associated with three issues: filing definitions, the individual Alternative Minimum Tax (AMT), and estimated taxes.[19] Other stakeholders (such as the National Taxpayer Advocate) made similar and more detailed proposals, and Congress ultimately adopted at least one of the IRS's recommendations in each of those areas:[20]

- Creating a uniform definition of a "qualifying child;"[21]
- Indexing the individual AMT exemption for inflation;[22] and
- Keeping the estimated tax safe harbor threshold constant.[23]

Similarly, in the 2002 report, which was still only 52 pages (excluding Appendix) the IRS highlighted options for reducing complexity associated with three more issues: personal credits, deductions and exemptions, and capital gains.[24] As with the 2000 report, Congress ultimately enacted at least one of the IRS's suggestions in each of those areas:

- Creating a uniform definition of a "qualifying child" for purposes of personal credits (as noted above);
- Coordinating the personal exemption and itemized deduction phase-out ranges;[25] and
- Reducing the number of capital gains rates.[26]

Given the seeming success of these relatively short reports that tackled only three issues each, the tax system would likely be simpler if the IRS had not discontinued them. According to the IRS, taxpayers have the *right to be informed* (*e.g.*, know and understand what they need to do to comply), *to quality service* (*e.g.*, to receive clear and easily understandable communications from the IRS), and *to a fair and*

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18 *Id*. at 11.

19 2000 Complexity Report at 1–2.

20 Others may have been adopted or included in bills, but the IRS was unable to identify any legislative activity associated with these particular recommendations. IRS response to TAS information request (July 15, 2014).

21 Working Families Tax Relief Act of 2004, Pub. L. No. 108–311, § 201, 118 Stat. 1166, 1169–1175 (2004) (enacting uniform definition of a qualifying child). The National Taxpayer Advocate and other stakeholders, including the American Bar Association (ABA) and the American Institute of Certified Public Accountants (AICPA) and the Tax Executives Institute (TEI), made similar and more comprehensive recommendations. *See, e.g.*, National Taxpayer Advocate 2001 Annual Report to Congress 78–100; ABA/AICPA/TEI Tax Simplification Recommendations (Sept. 13, 2002) (Attachment A).

22 The American Taxpayer Relief Act of 2012 (ATRA), Pub. L. No. 112–240, 126 Stat. 2317 (Jan. 2, 2013) (indexing the AMT exemption amount for inflation). The National Taxpayer Advocate and other stakeholders made similar recommendations. *See, e.g.*, National Taxpayer Advocate 2001 Annual Report to Congress 82–100.

23 The National Taxpayer Advocate had also observed that fluctuation of the estimated tax penalty threshold was a problem requiring a legislative solution. *See, e.g.*, National Taxpayer Advocate 2001 Annual Report to Congress 256. The threshold has remained at 110 percent of the tax shown on the prior year return for about the last ten years. *See* IRC § 6654(d)(1)(C)(i).

24 2002 Complexity Report at 9.

25 ATRA, Pub. L. No. 112–240, Title I, § 101(b)(2), 126 Stat. 2313, 2317 (Jan. 2, 2013) (codified at IRC §§ 68(b) and 151(d)(3)) (modifying the personal exemption phase-out (PEP) threshold amounts to be the same as those applicable to the limitation on itemized deductions (called "Pease"), as recommended).

26 *See* The Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108–27, Title III, § 301, 117 Stat. 752, 758 (May 28, 2003) (amending IRC § 1(h) and 55(b) to eliminate two capital gains rates for property held for five years or more).

just tax system.[27] Thus, if these reports ultimately improved tax law clarity, administrability, and fairness, they would promote these fundamental taxpayer rights.

Moreover, by issuing complexity reports, the IRS could show taxpayers that it understands the burden the tax laws impose on them, and that it is not always the cause of the problem—sometimes the law itself is the problem. Thus, regular complexity reports could also help to restore and maintain taxpayers' faith in the fairness of the tax system.

CONCLUSION

…Congress might be able to make steady progress toward simplification if it had a data-driven road map to highlight the areas of complexity that are causing the most problems for taxpayers and the IRS.

The complexity reports, which are typically relatively short, addressing only three issues each, provide a road map for stakeholders to address tax law complexity. This roadmap could help Congress improve tax law clarity, administrability, and fairness, thereby reducing burden and promoting fundamental taxpayer rights. Moreover, the reports could encourage the IRS to track how its employees are applying and observing taxpayer protections, specifically in the collection area.

Because complexity affects different taxpayers in different ways, the complexity reports could address the complexity facing different taxpayer segments. For example, over a rolling five-year period the IRS could issue one report addressing complexity faced by each of five different taxpayer groups, such as domestic individuals, tax exempt and government entities, international individuals and businesses, small business and self-employed taxpayers, and large businesses. In the sixth year, the IRS could revisit the complexity still facing the taxpayers discussed in the first report. If structured this way, the IRS's complexity reports are more likely to help Congress and other stakeholders address complexity faced by taxpayers throughout the tax system.

RECOMMENDATIONS

The National Taxpayer Advocate recommends the IRS:

1. Analyze and report to Congress each year on the sources of complexity in tax administration and on ways to reduce it, as required by law.
2. Issue a report addressing the complexity faced by a different taxpayer segment each year over a rolling multi-year period so that these reports address the complexity faced by taxpayers throughout the tax system.
3. Include in the complexity report all of the data suggested by Congress, including areas where employees make frequent errors interpreting or applying the law (*e.g.*, the errors collection employees make in applying taxpayer protection provisions).

27 *See* IRS, Pub. 1, *Your Rights as a Taxpayer* (2014).