WRITTEN STATEMENT OF

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Chairman Camp, Ranking Member Levin, and distinguished Members of the Committee:

Thank you for inviting me to testify today about the subject of tax reform. Let me begin by saying bluntly that, in my view, the tax code today is a mess. Since the last major reform 25 years ago, the tax code has become an ever-expanding patchwork of discrete provisions, often with little logical connection, and it has become unreasonably difficult for taxpayers to understand. In the National Taxpayer Advocate's 2010 Annual Report to Congress, I identified the complexity of the tax code and the confusion and distrust it engenders as the #1 most serious problem facing taxpayers – and the IRS. I titled that section "The Time for Tax Reform Is Now," because while there has been a lot of talk of tax reform in recent years, experience has shown that it will require a sustained, bipartisan effort – with the support of an engaged public – to make tax reform a reality.

In my testimony today, I will make the following points:

1. The tax code as it stands today imposes excessive compliance burdens on individual taxpayers and businesses.

2. The tax code is rife with complexity and special tax breaks, helping taxpayers who can afford expensive tax advice and discriminating against those who cannot.

3. Complexity obscures understanding and creates a sense of "distance" between taxpayers and the government, undermining taxpayer morale and leading to lower levels of voluntary compliance.

4. The complexity of the tax code is also burdensome for the IRS, making it more difficult for the agency to meet taxpayer needs and probably resulting in more audits and enforcement actions than a simpler code would require.

5. Despite the existence of many narrow special interest tax breaks, the overwhelming majority of tax breaks by dollar value accrue to large segments of the taxpaying public. If tax rates are to be lowered substantially and overall tax liabilities on average are to remain unchanged, virtually every taxpayer will have to give up cherished tax breaks. There is simply no free lunch. Yet I am convinced the "busy majority" of taxpayers wants fundamental tax simplification and will support it. Lower tax rates will offset the loss of tax breaks, and at the same time, taxpayers will understand how their taxes are computed and will save time and money on return preparation.

6. To assist Congress in deciding which tax breaks and IRS-administered social programs to retain and which to eliminate, I suggest utilizing a "zero-based budgeting" approach. Under that methodology, the starting point for discussion would be a tax code without 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 challenges that doing so creates for taxpayers and the IRS.

7. In my view, tax reform will have a better chance to succeed if it proceeds on a revenue-neutral basis and if decisions about whether and how much to adjust revenue levels are kept separate. I make that statement recognizing that with major tax provisions set to expire after 2012, even deciding the meaning of "revenue neutral" presents significant challenges. Although there is widespread recognition that we ultimately must take steps to reduce our current deficit levels, I believe that if we attempt to solve those issues through tax reform, we will never achieve structural tax reform. Rather, we will get stuck in partisan debates precisely when we need a calm and civil analysis of the structure of the tax code.

Before I delve into these issues, I wish to make two points clear. First, my statutory mandate is to address tax administration issues – not tax policy issues. While the line that separates tax administration and tax policy is sometimes fuzzy, I will try to describe the burdens that tax complexity imposes, identify challenges to enacting tax reform, and suggest some ways to approach it. However, my office does not take a position on tax rates, revenue levels, or the specifics of which tax breaks should be retained and which should be eliminated. Second, my statutory mandate is to present an independent taxpayer perspective. Therefore, although I am an IRS employee, my comments do not necessarily reflect the position of the IRS or the Administration.[1]

I. The Current Tax Code Imposes Excessive Compliance Burdens on Individuals 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.[2] And that figure does not include the millions of

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[1] The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

[2] The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form. While the IRS 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

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.[3]

- 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 income tax requirements for 2008 amounted to $163 billion – or a staggering 11 percent of aggregate income tax receipts.[4]

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. We note that the aggregate burden of 6.1 billion hours is lower than the 7.6 billion hour estimate included in our 2008 report. Analysts in the IRS Office of Research, Analysis and Statistics (RAS) have advised us that the lower burden estimates likely reflect efficiency gains attributable to wider use of tax software, particularly by higher income business taxpayers. However, these efficiency gains have not necessarily reduced the burden on middle income and lower income taxpayers. Indeed, measured by dollars, RAS estimates that the mean burden has declined but the median burden has increased. TAS cannot independently determine the margin of error of existing estimates, and RAS acknowledges that the reduction in the time burden estimates may be at least partially attributable to measurement error.

[3] 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).

[4] The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see Government Accountability Office, GAO-05-878, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System* (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. The TAS estimate of 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) was made by multiplying the total number of such hours (5.6 billion) by the average hourly cost of a civilian employee ($29.18), as reported by the Bureau of Labor Statistics. *See* Bureau of Labor Statistics, U.S. Department of Labor, *Employer Costs for Employee Compensation – December 2008*, USDL: 09-0247 (Mar. 12, 2009) (including wages and benefits), *at* http://www.bls.gov/news.release/archives/ecec_03122009.pdf. The TAS estimate of compliance costs as a percentage of total income tax receipts for 2008 was made by dividing the income tax compliance cost as computed above ($163 billion) by total 2008 income tax receipts ($1.45 trillion). *See* Office of Management and Budget, Budget of the United States Government - Fiscal Year 2011, Historical Tables, Table 2-1, *at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf.

TAS's estimate that compliance costs amount to about 11 percent of aggregate income tax receipts falls on the lower side 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.

- According to a tally compiled by a leading publisher of tax information, there have been approximately 4,428 changes to the tax code over the past 10 years, an average of more than one a day, including an estimated 579 changes in 2010 alone.[5]

- 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 3.8 million words.[6] A 2001 study published by the Joint Committee on Taxation put the number of words in the Code at that time at 1,395,000.[7] A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number had *almost tripled* since 1975.[8] (The methodologies underlying these word counts probably differed and the results therefore may not be comparable.)

- Individual taxpayers find return preparation so overwhelming that about 60 percent now pay preparers to do it for them.[9] Among unincorporated business taxpayers, the figure rises to about 71 percent.[10] An additional 29 percent of

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[5] Unpublished CCH data provided to TAS (Dec. 22, 2010).

[6] 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. 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 Feb. 1, 2010, so the count does not reflect legislation enacted during the second session of the 111th Congress. In Word, the document ran 11,045 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 there is no easy way to selectively delete information from a document of this length.

[7] *See* Staff of the Joint Committee on Taxation, 107th Cong., Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (vol. I), at 4 (Comm. Print 2001).

[8] J. 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.

[9] IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008); George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7 (presented at IRS Research Conference, June 2010).

[10] IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

individual taxpayers use tax software to help them prepare their returns,[11] with leading software packages costing $50 or more. IRS researchers estimate the monetary compliance burden of the median individual taxpayer (as measured by income) rose from $220 in 2000 to $258 in 2007, an increase of 17 percent.[12]

II. The Tax Code Is Rife with Complexity and Special Tax Breaks, Helping Taxpayers Who Can Afford Expensive Tax Advice and Discriminating Against Those Who Cannot.

The tax code contains a multitude of tax breaks that benefit narrow groups of taxpayers or industries. These tax breaks are enacted for understandable reasons, including to encourage certain types of behavior or to provide benefits in certain circumstances. While any list is necessarily selective, here is a small sampling of narrow benefits, either intended or incidental, for which the average taxpayer does not qualify:

- *Easement for Harmonious Shapes and Textures.* This provision allows donors of certain easements for conservation purposes to claim a charitable deduction, but it is almost impossible for the IRS to administer.[13] For example, it requires valuation of real property rights that preserve historic facades of houses or preclude development of open space, which under the tax regulations take into account such variables as the "harmonious variety of shapes and textures" on a landscape.[14]

- *Electric Vehicle/Golf Cart Credit.* This provision provides a credit for the purchase of qualified plug-in electric vehicles, which at one point included golf carts. While that loophole has been closed, the credit still covers the $100,000-plus Tesla sports car.[15]

- *Film and TV Deduction.* This provision allows taxpayers to expense costs associated with the production of films and television programs in lieu of the less generous depreciation deduction generally available to businesses.[16]

- *Forestry Conservation Bonds.* This provision authorizes a credit for investors in bonds issued by a government or non-profit entity for the purpose of acquiring at

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[11] George Contos, John Guyton, Patrick Langetieg & Melissa Vigil, *Individual Taxpayer Compliance Burden: The Role of Assisted Methods in Taxpayer Response to Increasing Complexity* 7 (presented at IRS Research Conference, June 2010).

[12] *Id.* at 26.

[13] *See* IRC § 170(h).

[14] Treas. Reg. § 1.170A-14(d)(4)(ii)(A)(5).

[15] *See* IRC § 30D.

[16] *See* IRC § 181.

least 40,000 acres adjacent to a national park, subject to a native fish habitat conservation plan of the U.S. Fish and Wildlife Service.[17]

- *Railroad Track Maintenance Credit:* This provision provides a special credit for taxpayers who happen to own a railroad.[18]

Beyond these narrow provisions, the tax code contains many general provisions that well-advised taxpayers may exploit. Indeed, many large accounting firms, law firms, and investment banking firms have regularly mined the code for ambiguities in order to develop tax-reduction "products" they can sell to paying clients.

At the same time that taxpayers who can afford pricey legal advice are benefiting disproportionately from tax breaks, unsophisticated taxpayers who could benefit from tax breaks sometimes fail to claim them because they do not know they exist. In 2006, for example, individual taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government had improperly collected.[19] The standard amount of the credit ranged from $30 to $60, depending on the number of exemptions the taxpayer was entitled to claim on the return.[20] No substantiation was required unless a taxpayer claimed a larger amount, so this credit was essentially free money. Yet IRS data show that 28 percent of eligible taxpayers (37 million out of 133 million) did not claim the credit.[21] Why would 37 million taxpayers fail to claim an authorized credit? The most likely explanation is that they never learned about it because they were already so overwhelmed by the complexity of their tax returns.[22]

Overall, the complexity of the tax code leads to perverse results. On the one hand, taxpayers who honestly seek to comply with the law often make inadvertent errors, causing them to either overpay their tax or become subject to IRS enforcement action for mistaken underpayments. On the other hand, sophisticated taxpayers often find arcane provisions that enable them to reduce or eliminate their tax liabilities.

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[17] *See* IRC §§ 54A & 54B.

[18] *See* IRC § 45G.

[19] *See* IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section, the telephone excise tax refunds were authorized by the Department of the Treasury after several circuits of the U.S. Court of Appeals ruled that the long-distance telephone services at issue were not subject to taxation.

[20] IRS News Release, *IRS Announces Standard Amounts for Telephone Tax Refunds*, IR-2006-137 (Aug. 31, 2006).

[21] IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008).

[22] One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008). An alternative explanation we have heard from preparers is that some taxpayers were concerned that claiming the credit might increase their audit risk. To the extent that some taxpayers had this concern, it provides further evidence of the disconnect between taxpayers and the government and the need to make the tax system more transparent.

III. 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. IRS studies show that nonfarm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.[23]

Noncompliance cheats honest taxpayers, who must pay more to make up the difference. According to the IRS's most recent comprehensive estimate, the net tax gap stood at $290 billion in 2001,[24] when 132 million tax returns were filed.[25] This means that each taxpayer was effectively paying a "surtax" of some $2,200 to subsidize noncompliance by others.

To me, this raises an important question: Why is it that few Americans would steal from 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 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. 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 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

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[23] *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006) (accompanying charts at http://www.irs.gov/newsroom/article/0,,id=154496,00.html). 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.

[24] *See* IRS News Release, *IRS Updates Tax Gap Estimates*, IR-2006-28 (Feb. 14, 2006).

[25] IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2001).

not understand how their tax dollars are spent or how they benefit. Or it may be because they know the leaders of local community groups personally, while the government is faceless. Either way, I suspect that stealing from a local charity feels to many like stealing from family and friends, while cheating on one's taxes feels to some like a victimless offense.[26]

For these reasons, I think it is important to increase taxpayer awareness of the connection between taxes paid and benefits received. I have recommended that Congress direct the IRS to provide all taxpayers with a "taxpayer receipt" showing how their tax dollars are being spent. This "taxpayer receipt" could be a more detailed version of the pie chart currently published by the IRS but should be provided directly to each taxpayer annually.[27] I believe better public awareness of the connection between taxes and government spending may improve civic morale, increase tax compliance, and make more productive the national dialogue over looming fiscal policy choices as well.

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

The IRS employs about 100,000 workers[28] and performs many of its tasks very well, but it faces daunting challenges in administering the tax code. Despite the fact that about 90 percent of individual taxpayers rely on preparers or tax software packages, the IRS received 110 million calls in each of the last two fiscal years.[29] That is a staggering volume of calls, and not surprisingly, the IRS was unable to answer over 25 percent of them.[30] In FY 2008, the IRS received approximately 167 million calls,[31] largely inquiries generated by the Economic Stimulus Act,[32] and it was only able to answer 53 percent.[33]

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[26] *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).

[27] *See* IRS Form 1040 Instructions (2009), at 100.

[28] IRS Data Book, 2009, Table 31 *at* http://www.irs.gov/pub/irs-soi/09db31ps.xls.

[29] IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (weeks ending Sept. 30, 2009 and Sept. 30, 2010).

[30] The Customer Account Services Level of Service was 70 percent in FY 2009 and 74 percent in FY 2010. *See* IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (weeks ending Sept. 30, 2009 and Sept. 30, 2010). These percentages reflect the number of calls that reached telephone assisters among all callers seeking to do so.

[31] IRS, Joint Operations Center, *Snapshot Reports: Enterprise Snapshot* (week ending Sept. 30, 2008).

[32] Pub. L. No. 110-185 (2008).

[33] IRS, Joint Operations Center, *Snapshot Reports: Customer Account Services – CAS* (week ending Sept. 30, 2008).

In our 2010 Annual Report to Congress, we describe other key challenges facing the IRS. To cite one example, the IRS cannot process on a timely basis a considerable portion of the more than 11 million pieces of taxpayer correspondence it receives each year. This situation leads to erroneous tax assessments, improper collection actions, additional penalties and interest for taxpayers, and additional refund interest costs to the government.[34] To cite another example, the IRS relies heavily on automated processes to achieve efficiencies, but in doing so, it sometimes fails to address the unique circumstances of individual taxpayers. The dramatic increase in automated lien filings over the past decade and the IRS's unwillingness to require its employees to make individualized lien determinations are also described in our most recent report.[35]

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.

V. The Dirty Little Secret: Tax Breaks Generally Benefit the Masses.

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, including several described above. But the dirty little secret is that the largest special interests are us – the vast majority of U.S. taxpayers. Virtually all of us benefit from tax breaks that are technically called "tax expenditures." A tax expenditure is generally defined as any reduction in tax revenue attributable to an exclusion, exemption, or deduction from gross income or a credit, preferential tax rate, or deferral of tax.[36]

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[34] *See* National Taxpayer Advocate 2010 Annual Report to Congress 235-249 (Most Serious Problem: *The IRS Does Not Process Vital Taxpayer Responses Timely).*

[35] *See* National Taxpayer Advocate 2010 Annual Report to Congress 302-310 (Status Update: *The IRS Has Been Slow to Address the Adverse Impact of Its Lien Filing Policies on Taxpayers and Future Tax Compliance).*

[36] 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. 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).*

In December 2010, the Joint Committee on Taxation (JCT) published its annual analysis of tax expenditures for the five-year period FY 2010 through FY 2014, and the largest were the following:[37]

- The exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance ($659.4 billion).
- The exclusion for retirement plan contributions and earnings ($596.5 billion).[38]
- The mortgage interest deduction for owner-occupied housing ($484.1 billion).
- The reduced rates of tax on dividends and long-term capital gains ($402.9 billion).
- The exclusion for various Medicare benefits ($337.1 billion).[39]
- The earned income tax credit ($268.8 billion).[40]
- The deduction for nonbusiness state and local taxes ($237.3 billion).
- The exclusion of capital gains at death ($194.0 billion).
- The deduction for charitable contributions ($187.5 billion).

Other popular benefits include the child and dependent care credits and exclusions for distributions from Roth IRAs, for distributions from Section 529 education savings plans, for contributions to Flexible Spending Accounts (both medical and dependent care), and for public transportation subsidies.

Another perspective: On an annual basis, the JCT estimates that tax expenditures total about $1.1 trillion a year.[41] As compared with about 138 million individual tax returns filed in 2010,[42] that amounts to an average reduction in tax per return of about $8,000.

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[37] *See* Staff of the Joint Committee on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014,* Table 1 (Joint Comm. Print 2010).

[38] This total represents the sum of defined benefit plans ($303.2 billion), defined contribution plans ($212.2 billion), and plans covering partners and sole proprietors (sometimes known as “Keogh” plans) ($81.1 billion).

[39] This total represents the sum of hospital insurance - Part A ($175.8 billion), supplementary medical insurance - Part B ($124.5 billion), prescription drug insurance - Part D ($35.1 billion), and exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees ($1.7 billion).

[40] This estimate reflects the full value of the EITC, including the refundable portion associated with significant outlay effects. *See* Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, Table 1, at 52 n.5.

Because tax is computed as a percentage of income, the total amount of exclusions or deductions that would generate an $8,000 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 $8,000 would translate to deductions or exclusions from income worth $32,000.

Example

> A single parent with two children under 17 receives income and benefits totaling $100,000 in 2010. Included in this amount are "tax expenditures" of $32,000 (consisting of exclusions of $16,000 for employer-provided health insurance and retirement plan contributions and deductions of $16,000 for mortgage interest, state and local taxes, and charitable contributions). In addition, the parent receives the benefit of personal and dependency exemptions – one for herself and one for each child – totaling $10,950.[43] Therefore, the taxpayer reduces her $100,000 starting total by $42,950 (the sum of tax expenditures for which she qualifies and three exemptions) to arrive at a taxable income of $57,050. Under the 2010 rate tables, the taxpayer computes a federal income tax of $9,120, which is reduced by a child tax credit of $1,550 and a Making Work Pay credit of $400, for a net total tax of $7,170. Thus, despite the fact that this taxpayer falls into the 25-percent marginal tax rate bracket, she ends up paying an average rate of tax of about 7 percent of her income and excluded benefits.[44]

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[41] *See* Staff of the Joint Committee on Taxation, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (Joint Comm. Print 2010). The JCT provides a separate estimate for each tax expenditure, but it does not add them up to provide an aggregate total. Tax expenditures have interactive effects for which the JCT has not attempted to account. If those effects were incorporated, the aggregate total of foregone revenue would be somewhat lower. Nevertheless, the aggregate total provides a reasonable approximation of the level of 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, 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").

[42] *See* IRS 2010 Filing Season Statistics *at* http://www.irs.gov/newsroom/article/0,,id=220953,00.html.

[43] The JCT does not consider either personal exemptions or the standard deduction 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, 111th Cong., *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014,* at 4-5 (Joint Comm. Print 2010). Therefore, they reduce income further.

[44] Because tax rates rise with income, this taxpayer pays tax at 10 percent on the first $11,950 of taxable income, at 15 percent on taxable income between $11,950 and $45,550, and at 25 percent on additional income. We are assuming that this taxpayer uses head-of-household filing status.

In Appendix A, we present tax computations that illustrate the role of tax expenditures in four different situations – a married couple with two children, a small business owner, a low income single parent, and a retired couple. The scenarios are fictitious, but they illustrate the extent to which a variety of tax benefits may apply to different types of taxpayers. Moreover, although most of my testimony today is focused on individual taxpayers, I believe the rationale for trading lower rates for a simpler tax code applies to the taxation of businesses as well. The scenario involving a small business owner provides one illustration of this point.

These scenarios make clear that tax reform is not an easy issue. In theory, 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.[45] 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, I personally believe that fundamental tax reform is essential and urgent. More importantly, I believe that taxpayers will support tax reform by wide margins if they gain a better understanding of the trade-offs involved and are engaged in 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 more transparent system. 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.

Both to gauge and build public support, I encourage you to discuss with your constituents both the complexity of the existing tax code and the trade-offs between tax rates and tax breaks that tax reform will require. An uninformed taxpayer who hears he may lose a tax break will instinctively seek to retain it to prevent his tax bill from rising. An informed taxpayer who understands she will be losing a tax break but probably will not pay more tax because rates will be substantially lowered will have a very different reaction. The Tax Reform Act of 1986 was the last major revision of the tax code, and despite considerable initial concerns, taxpayers came around. On the final votes, the Act was supported by significant bipartisan majorities in the House and the Senate.[46] I am hopeful and optimistic that a similar dynamic will play out again in the near future.

To help promote a public dialogue, my office recently launched a web page at www.taxpayeradvocate.irs.gov to solicit taxpayer suggestions regarding tax reform. We promised to track and post comments periodically. We asked taxpayers to approach

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[45] The bipartisan fiscal commission appointed by the President recently 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.

[46] 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).

this with the frame of mind that everything – even the tax breaks from which they benefit personally – should be on the table. All of us should consider which tax breaks we would be willing to give up in exchange for simplification of the tax code, and which provisions we think are unduly burdensome or unfair. To date, we have received more than 1,000 comments. I have been amazed by how seriously taxpayers have taken this request and by the extraordinary thoughtfulness and good sense so many of them have exhibited in their suggestions. I believe that as taxpayers understand more about the sources of current tax law complexity, their desire for tax reform and support for their legislators' making hard choices will increase.

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

My suggestion is to 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.[47]

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, I 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.[48] In addition, in our 2009 report I proposed an analytic framework for evaluating whether specific social

[47] *See* National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (*Evaluate the Administration of Tax Expenditures*).

[48] *See id.*

benefit programs – whether for individuals or for businesses – should be run through the tax system.[49]

If, in the context of structural tax reform, we apply this rigorous analytical framework to all proposed tax expenditures, we will adopt 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 thus understand why such a provision is included in the tax code and will be able to ascertain its effectiveness.

This approach, at a conceptual level, is similar to two other proposals presented during the past year. In December 2010, the National Commission on Fiscal Responsibility and Reform issued a report that, among other things, also recommended a zero-based budgeting approach to tax reform.[50] In February 2010, Senators Wyden and Gregg introduced legislation that would substantially revamp the tax code.[51] While we do not endorse specific proposals, we think both are thoughtful and worthy starting points.

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.[52] 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.[53] But

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[49] 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 an eligibility determination, and the IRS's suitability to be the administrator of the provision in light of its enforcement culture.

[50] *See* National Commission on Fiscal Responsibility and Reform, *A Moment of Truth*, at 28-34 (Dec. 2010) *at* http://www.fiscalcommission.gov/news/moment-truth-report-national-commission-fiscal-responsibility-and-reform. The mandate of the commission was to address the nation's long-term fiscal challenges, and as a result, its tax reform recommendations are partly designed to increase revenue. It is beyond the mission of the National Taxpayer Advocate to take a position on these broader fiscal issues.

[51] Bipartisan Tax Fairness and Simplification Act, S. 3018, 111th Cong. (2010).

[52] For example, the IRS in some cases already has access to all the financial or other data necessary 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.

[53] 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

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

Two additional notes: In a presentation to the President's Advisory Panel on Federal Tax Reform in 2005, I laid out certain principles for tax reform that I view as important from a taxpayer perspective.[54] These principles are included as Appendix B. In addition, the National Taxpayer Advocate's Annual Reports to Congress over the past decade have offered numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of comprehensive structural tax reform in mind, they provide an additional illustration of tax-law complexity and should serve as a checklist to ensure that key areas of complexity are addressed in tax reform legislation. A summary of these proposals is included as Appendix C.

VII. The Odds of Achieving Tax Reform Are Higher if the Issue Is Addressed Separately from Decisions About Adjustments to Revenue Levels.

Although my office does not take a position on fiscal policy issues or tax rates, I am mindful that leaders of both parties have expressed deep concerns about the long-term structural imbalance between government revenues and government spending, and that in addition to spending cuts, tax revenues at some point may have to be increased. I am also mindful that the question of whether and to what extent to raise revenue is extremely contentious.

If comprehensive structural tax reform and revenue levels are considered together as part of a package, I am concerned that the debate over revenue levels could overshadow and derail meaningful tax reform. Therefore, my suggestion is that Congress consider addressing these issues separately. First, Congress could enact comprehensive structural tax reform on a revenue-neutral basis. Second, Congress could decide on appropriate revenue levels and adjust the tax rates as it deems appropriate.

VIII. Conclusion: The Time for Tax Reform Is Now.

For all the reasons described above, I 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 $163 billion that taxpayers spend on return preparation; increase the likelihood that taxpayers will claim all tax benefits to which they are entitled; reduce the

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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*).

[54] *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate). For additional detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

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 – and perhaps even 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 nearly 300,000 taxpayer cases a year, lowering rates in exchange for broadening the tax base seems like an excellent bargain. I am confident that in the end, public support for a simpler code will be strong and deep.

APPENDIX A

Example 1: MARRIED COUPLE WITH TWO CHILDREN

Taxpayer *A* is married with two children under 17. *A* works for a large company that pays him $75,000 annually. Of this, *A* directs $5,000 of his earnings into a retirement plan (401(k)), and the company matches his contribution with $5,000. *A* directs another $5,000 of his earnings into a Flexible Spending Account (FSA) for out-of-pocket medical expenses, while the company provides health insurance coverage worth $13,000 for *A* and his family. Further, the company provides *A* with a commuter transit subsidy worth $2,000. Because these employee benefits (including the voluntary salary reductions for the 401(k) and FSA) are not included in gross income for tax purposes, *A*'s "adjusted gross income" is only $65,000.

A pays home mortgage interest of $10,000, state, local, and property taxes of $5,000, and charitable contributions of $2,000. *A*'s wife enrolls in community college courses for which an education tax credit of $1,000 is allowed. In addition to a $3,650 exemption for each member of the family, a $1,000 child tax credit for each child and a Making Work Pay credit for *A* and his wife are allowed.

Although *A*'s pay was $75,000, rising to $95,000 with pre-tax benefits, his taxable income was only $33,400 after subtraction of exclusions and deductions. The marginal tax rate on this amount would be 15 percent, for a tax of about $4,200. After tax credits, *A* pays approximately $400, which is 0.4 percent of his $95,000 of income and benefits.

Table 1. Tax Treatment

Category	Item	Amount ($)	Net ($)
Income including benefits	Salary	75,000	
	Retirement (employer match)	5,000	
	Health insurance (employer-provided)	13,000	
	Transit subsidy	2,000	95,000
Exclusions	FSA	5,000	
	Retirement (employer & employee parts)	10,000	
	Health insurance	13,000	
	Transit subsidy	2,000	(30,000)
Deductions	Mortgage interest	10,000	
	State, local, and property tax	5,000	
	Charitable contributions	2,000	
	Exemptions	14,600	(31,600)
Taxable income	(15% marginal bracket)		33,400
Tax (rounded)			4,200
Credits	Child	2,000	
	Education	1,000	
	Making Work Pay	800	(3,800)
Net tax	(0.4% result)		400

Example 2: SMALL BUSINESS OWNER

Taxpayer B operates as a sole proprietor his own contracting business that grosses almost half a million dollars yearly, but after the costs of equipment and supplies, yields income of $200,000 out of which he pays expenses such as wages, licenses, insurance, fees, and advertising of $25,000. Late in 2010, B bought a new SUV of over 6,000 pounds that he drove solely for business that year. Under a provision for “bonus” depreciation, the full $60,000 price is deductible. Because B’s contracting business is considered to be a domestic production activity, he also can deduct about $5,000 of “qualified production activities income.” Through the business, B obtains health insurance for $10,000 and puts away another $10,000 for retirement (in a simplified employee pension plan known as a SEP). As a self-employed proprietor, B must pay about $14,850 in self-employment (SE) tax, but half of this is deductible.

Mrs. B earns $25,000 as a kindergarten teacher, buying classroom supplies out-of-pocket of which she can deduct $250. The Bs pay $10,000 in state, local, and property tax, $10,000 in home mortgage interest, and $5,000 in charitable contributions.

Although the Bs have income of $200,000, the deduction of numerous tax expenditures brings them down into the 25-percent bracket (and the Alternative Minimum Tax does not apply to this situation). For income tax purposes, after an $800 Making Work Pay credit, B pays about $10,300, or 5 percent of the $200,000. In addition, B pays about $14,850 of SE tax (the counterpart to certain payroll tax on employees).

Table 2. Tax Treatment

Category	Item	Amount ($)	Net ($)
Income	Business income after expenses	175,000	
	Salary	25,000	200,000
Deductions	Bonus depreciation	60,000	
	Domestic production	5,000	
	Health insurance (SE)	10,000	
	Retirement (SEP)	10,000	
	½ SE tax (rounded)	7,400	
	Schoolteacher expenses	250	
	State, local, and property taxes	10,000	
	Mortgage interest	10,000	
	Charitable contributions	5,000	
	Exemptions	7,300	(124,950)
Taxable income (25% marginal bracket)			75,050
Income tax	(rounded)		11,100
Credit	Making Work Pay		(800)
Net tax	(5% result)		10,300

Example 3: LOW INCOME SINGLE PARENT

Taxpayer C is single with a child under 17. C earns $10,000 from minimum-wage work, but also has received unemployment compensation of $1,000. C is eligible for the standard deduction and two exemptions, which more than offset C's income. Moreover, C qualifies for several refundable credits – the Making Work Pay credit, the earned income tax credit and the additional child tax credit. The result is a "negative" tax paid to C by the U.S. government of about 40 percent of $11,000.

Table 3. Tax Treatment

Category	Item	Amount ($)	Net ($)
Income	Wages	10,000	
	Unemployment compensation	1,000	11,000
Deductions	Standard	8,350	
	Exemptions	7,300	(15,650)
Taxable income	(10% marginal bracket)		-0-
Tax			-0-
Credits	Making Work Pay	400	
	Earned Income	3,050	
	Additional child	1,000	(4,450)
Negative tax	(-40% result)		(4,450)

Example 4: RETIRED COUPLE

Taxpayer D, age 70, is retired after a career in the public and private sectors (during which she paid into public and private retirement funds). Her husband, age 60, is blind. They receive Social Security benefits of $24,000, the taxable portion of which is $20,000. From former jobs, D receives public and private pensions of $27,000. The IRS could determine the taxable portion for a $1,000 fee, but as a financially educated professional, D is able to calculate the taxable portion at $23,000. D receives tax-free municipal bond interest of $1,000. Additionally, D owns a real estate investment that generates rent of $5,000, which covers $4,000 of mortgage interest and other operating expenses, but after depreciation, results in an allowable passive activity loss of $1,000.

D takes a standard deduction of $11,400 for a married couple filing jointly. D and Mr. D qualify for an $1,100 additional standard deduction for the elderly and an $1,100 additional standard deduction for the blind. They also take two $3,650 personal exemptions.

Thus, D has income of $45,000, less an exclusion of certain investment income, and finally reduced by deductions. Ultimately, the tax bill of $2,300 is five percent of the incoming $45,000.

Table 4. Tax Treatment

Category	Item	Amount ($)	Net ($)
Income	Social Security	20,000	
	Pensions	23,000	
	Muni-bond interest	1,000	
	Rent after operating expenses	1,000	45,000
Exclusion	Muni-bond interest	1,000	(1,000)
Deductions	Rental depreciation	2,000	
	Standard deduction	11,400	
	Additional standard deduction	2,200	
	Exemptions	7,300	(22,900)
Taxable income	(15% marginal bracket)		21,100
Tax (rounded)	(5% result)		2,300

APPENDIX B

TAX REFORM PRINCIPLES RECOMMENDED BY THE NATIONAL TAXPAYER ADVOCATE

The National Taxpayer Advocate has recommended six core taxpayer-centric principles to help guide the development of tax reform legislation:

1. The tax system should not "entrap" taxpayers.

2. The tax code should be simple enough so that most taxpayers can prepare their own returns without professional help, simple enough so that taxpayers can compute their tax liabilities on a single form, and simple enough so that IRS telephone assistors can fully and accurately answer taxpayers' questions.

3. The tax code should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.

4. The tax code should provide some choices, but not too many.

5. Where the tax code provides for refundable credits, the credits should be designed in a way that the IRS can effectively administer.

6. The tax code should incorporate a periodic review of itself – in short, a sanity check.[1]

[1] The National Taxpayer Advocate previously articulated these principles in a presentation to the President's Advisory Panel on Federal Tax Reform. *See* Public Meeting of the President's Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Nina E. Olson, National Taxpayer Advocate). For additional detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Legislative Recommendation: *A Taxpayer-Centric Approach to Tax Reform*).

APPENDIX C

SIMPLIFICATION PROPOSALS RECOMMENDED BY THE NATIONAL TAXPAYER ADVOCATE

Over the past decade, the National Taxpayer Advocate's Annual Reports to Congress have made numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of comprehensive structural tax reform in mind, they should be considered as part of an overall tax reform process. A summary of our key proposals follows:

Repeal the Alternative Minimum Tax (AMT) for Individuals. 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. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. 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.[1]

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 of the home – are difficult for the IRS to verify without conducting

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[1] 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).

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.[2]

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.[3]

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.[4]

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[2] *See* 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*).

[3] *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*).

[4] *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.[5]

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 incentives, the large number of options and 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 plan 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.[6]

Simplify Worker Classification Determinations to Minimize Employee-versus-Independent Contractor Disputes. The complexity of, and ambiguities in, the existing worker classification rules create uncertainty and lead to noncompliance. In general, businesses are only required to pay and withhold employment tax, withhold income tax, and provide benefits with respect to employees. Consequently, businesses often classify workers as independent contractors to reduce their costs. Some employees seeking to avoid their tax obligations may also prefer to be classified as contractors if the employer does withhold taxes or report the payments for employees to the IRS. Depending on the terms of the relationship between a business and a worker, however, many workers should be classified as independent contractors. The National Taxpayer Advocate has recommended that Congress (1) replace § 530 of the Revenue Act

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[5] *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*).

[6] *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*).

of 1978 with a provision applicable to both employment and income taxes and require the Secretary to issue associated guidance, including guidance with specific industry focus; (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.[7]

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets. The tax code contains more than 100 provisions that are temporary and set to expire soon, up from about 21 in 1992. Tax benefits have increasingly been enacted for a limited number of years in order to reduce their cost for budget-scoring purposes. Tax sunsets make it difficult for both the government and taxpayers to plan ahead, 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.[8]

Eliminate (or Simplify) Phase-Outs. More than 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 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.[9]

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[7] *See* National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: *Worker Classification*).

[8] *See id.* at 397-409 (Legislative Recommendation: *Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets*).

[9] *See id.* at 410-413 (Legislative Recommendation: *Eliminate (or Simplify) Phase-outs*).

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 recommended 11 steps that could be taken immediately.[10]

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[10] *See id.* at 414-418 (Legislative Recommendation: *Reforming the Penalty Regime),* and vol. 2, at 1-44 (Research Study: *A Framework for Reforming the Penalty Regime*).