

OPINION POINT

The Complexity of the Tax Code

- Section 7803 requires the National Taxpayer Advocate to prepare an Annual Report to Congress that includes, among other things, legislative recommendations to resolve problems encountered by taxpayers. In the second of an annual series, *NewsQuarterly* publishes a part of the Annual Report. In her 2008 Annual Report to Congress, the National Taxpayer Advocate, Nina E. Olson, recommended that Congress address the growing complexity of the Internal Revenue Code. As indicated in a recent white paper, *Statement of Policy Favoring Tax Simplicity, Stability and Transparency*, published in the Fall 2008 *NewsQuarterly*, the Tax Section is also concerned about complexity.

Selected portions of “The Complexity of the Tax Code” are reproduced below. The *NewsQuarterly* encourages readers to submit responses or comments, which may be published in a subsequent issue.—*Christopher M. Pietruszkiewicz, Vice Chancellor for Business and Financial Affairs and J.Y. Sanders Professor of Law, LSU Law Center, Baton Rouge, LA*

The largest source of compliance burdens for taxpayers—and the IRS—is the overwhelming complexity of the tax code. The only meaningful way to reduce these burdens is to simplify the tax code enormously.

Consider the following:

- According to a TAS [Taxpayer Advocate Service] analysis of IRS data, U.S. taxpayers and businesses spend about 7.6 billion hours a year complying with the filing requirements of the Internal Revenue Code. And that figure does not even include the millions of additional hours that taxpayers must spend when they are required to respond to an IRS notice or an audit.
- If tax compliance were an industry, it would be one of the largest in the United States. To consume 7.6 billion hours, the “tax industry” requires the equivalent of 3.8 million full-time workers.
- Compliance costs are huge both in absolute terms and relative to the amount of tax revenue collected. Based on Bureau of Labor Statistics (BLS) data on the hourly cost of an

employee, TAS estimates that the costs of complying with the individual and corporate income tax requirements in 2006 amounted to \$193 billion—or a staggering 14 percent of aggregate income tax receipts.

- Since the beginning of 2001, there have been more than 3,250 changes to the tax code, an average of more than one a day, including more than 500 changes in 2008 alone.
- The Code has grown so long that it has become challenging even to figure out how long it is. A search of the Code conducted in the course of preparing this report turned up 3.7 million words. 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. A 2005 report by a tax research organization put the number of words at 2.1 million, and notably, found that the number of words in the Code has *more than tripled* since 1975.

- Tax regulations, which are issued by the Treasury Department to provide guidance on the meaning of the Internal Revenue Code, now stand about a foot tall. The CCH Standard Federal Tax Reporter, a leading publication for tax professionals that summarizes administrative guidance and judicial decisions issued under each section of the Code, now comprises 25 volumes and takes up nine feet of shelf space. Two companies publish newsletters *daily* that report on new developments in the field of taxation; the print editions often run 50-100 pages and the electronic databases contain substantially more detailed information.

- Individual taxpayers find the return preparation process so overwhelming that more than 80 percent pay transaction fees to help them file their returns. About 60 percent pay preparers to do the job, and another 22 percent purchase tax software to help them perform the calculations themselves.

The Office of the Taxpayer Advocate sees dozens of examples of the impact of tax law complexity each year.

- **Excessive Number of Education and Retirement Savings Incentives.** The Code currently contains at least 11 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 Code also contains at least 16 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. Taxpayers wishing to choose the optimal vehicle to save for college must know the difference between a Section 529 plan, a Coverdell Education Savings Account, and the Hope and Lifetime Learning Credits, among other alternatives. Taxpayers wishing to choose the optimal plan in which to save for retirement must know the difference between a traditional IRA, a Roth IRA, a Section 401(k) plan, a Section 403(b) plan, and a SARSEP, among others.

- **The Alternative Minimum Tax (AMT).** The AMT concept, originally enacted in response to a report that 155 high-income taxpayers had paid no tax for the 1966 tax year, now effectively requires taxpayers to compute their taxes twice—once under the regular rules and again under the AMT regime—and then to pay the higher of the two amounts. The AMT was originally conceived to prevent wealthy taxpayers from escaping tax liability through the use of tax-avoidance transactions. However, most of the significant tax loopholes that enabled taxpayers to escape tax at the time the AMT was written have long since been closed, and it is now estimated that about 77 percent of the additional income subject to tax under the AMT is

attributable simply to family size or residing in a high-tax state. 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 how those actions are treated. Yet government has become so dependent on AMT revenue that Congress to date has been unwilling to make permanent changes in law to curtail the AMT, and it is not likely that such changes will be made outside the context of major tax reform.

- **Tax Consequences of Mortgage Foreclosures and Canceled Debts.** Most financially distressed individuals who lose their homes to foreclosure or cannot pay off their car loans, credit card balances, student loans, or medical bills probably do not realize that their delinquency may increase their tax liabilities, but it often does. If a creditor writes off a debt, the tax code generally treats the amount of the canceled debt as taxable income to the debtor. Congress has carved out a number of exclusions, including a recently enacted exclusion to help homeowners whose mortgage debts are canceled when their houses are foreclosed upon and sold. However, taxpayers do not receive the benefit of these exclusions automatically. A taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to claim an exclusion. Form 982 is extremely complex, and very few taxpayers or preparers are familiar with it. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete the form, and the form is not included in many tax software packages available to taxpayers.

- IRS data shows that approximately two million Forms 1099-C, *Cancellation of Debt*, are issued to

taxpayers each year reporting canceled debts. The National Taxpayer Advocate estimates that tens of thousands and possibly hundreds of thousands of taxpayers who qualify to exclude canceled debts from gross income do not file Form 982 to claim allowable exclusions. Instead, some of these taxpayers unnecessarily include the amount of the canceled debt in gross income, and other taxpayers who fail to include it unnecessarily face IRS examinations and tax assessments.

- **Earned Income Tax Credit (EITC) Complexity.** About 22 million low income taxpayers claim the EITC each year. The eligibility requirements and computations are complex, yet EITC recipients are relatively less able to understand complex rules and less likely to speak English as their primary language, creating a recipe for confusion.

- EITC complexity leads to improper claims by taxpayers—some intentional but many inadvertent—and to improper denials by the IRS. A 2004 TAS study surveyed cases in which the IRS denied an EITC claim on audit but the taxpayer asked the IRS to reconsider its findings. Despite the initial IRS denials, the study found that taxpayers ultimately obtained some or all of the EITC amount they had claimed on their returns in 43 percent of the cases (and they received, on average, 94 percent of the amount they had originally claimed).

- Another window into EITC complexity: One might expect that low income taxpayers would be less likely to need return preparers because their sources of income are often limited to wages and perhaps interest income, yet 72.5 percent of taxpayers who claim the EITC use tax preparers.

■ **Proliferating 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. . . . If taxpayers do not know whether a tax benefit will remain in the Code, the incentive is less likely to influence their decision-making, thereby undermining its purpose. The uncertainty associated with an expiring tax benefit also makes it difficult for taxpayers to estimate their tax liabilities and pay the correct amount of estimated tax, potentially subjecting them to penalties and causing disillusionment with the tax system.

■ **Phase-out Complexity.** More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits. . . . [T]here are about 100 phase-outs [and] [l]ike tax sunsets, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. However, phase-outs add substantial complexity and 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. This inequity is largely hidden by the complexity of the phase-out calculations.

■ **Unclaimed Telephone Excise Tax Refunds.** In 2006, taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government concluded it had improperly collected in the past. The amount of the credit ranged from \$30 to \$60, depending on the number of personal exemptions the taxpayer was entitled to claim on the return. 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 133.2 million) did not claim the credit. The only plausible explanation is that taxpayers missed the credit because of the complexity of the law and the tax forms.

■ **Burgeoning Penalties.** The number of civil penalties in the Code has grown from about 14 in 1954 to approximately 130 today. Penalties should be designed to enhance voluntary tax compliance, but they also should be reasonable and can only influence future taxpayer behavior if taxpayers are aware that the penalties exist. As a consequence of “penalty creep,” some penalties are obscure or unduly harsh. . . .

■ **Small Business Burdens.** Small business taxpayers face a particularly bewildering array of laws, including a patchwork set of rules that governs the depreciation of equipment, numerous and

overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious “correct” answer.

To assist the Congress in pursuing tax simplification, [the Report includes] a number of proposals in the Legislative Recommendations section. In doing so, [the National Taxpayer Advocate] recommends that emphasis be given to six core principles:

1. The tax system should not “entrap” taxpayers.
2. The tax laws 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 assistants can fully and accurately answer taxpayers’ questions.
3. The tax laws should anticipate the largest areas of noncompliance and minimize the opportunities for such noncompliance.
4. The tax laws should provide some choices, but not too many choices.
5. Where the tax laws provide for refundable credits, they should be designed in a way that is administrable; and
6. The tax system should incorporate a periodic review of the tax code—in short, a sanity check. ■

LISTEN TO NINA OLSON DISCUSS HER REPORT

Nina Olson, *IRS National Taxpayer Advocate*, discussed the major findings and recommendations from her 2008 Annual Report to Congress in a 90-minute Tax Section CLE teleconference on February 10, 2009.

As with all Tax Section teleconferences, the audio recording of this presentation can be purchased in MP3 or CD-ROM formats from the ABA webstore. Go to www.ababooks.org, and search “Taxpayer Advocate” in the CLE Products category for more information.