OPINION POINT

The Time for Tax Reform Is Now

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 her 2010 Annual Report to Congress, the National Taxpayer Advocate, Nina E. Olson, described the complexity of the Internal Revenue Code, advocated for reform, and suggested that the time for reform is now. In the fourth of an annual series, *NewsQuarterly* publishes excerpts of the Annual Report.

The Annual Report of the Taxpayer Advocate follows a report in December 2010 by President Obama's Fiscal Commission and precedes a major initiative by the Section—the Tax Reform Comment Project—to take a more active role in the tax legislative process, in which each Section committee is being asked to prepare comments for submission to Congress to assist it in its efforts to reform the nation's tax laws with particular emphasis on suggestions for simplification.

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.

Our number one most serious problem and number one legislative recommendation go into the data in detail and provide a good sense of what tax complexity does to each and every one of our lives. It is not good. But if we all agree that tax reform is necessary, why hasn't it happened? Well, our answer to this question is that we are all unwilling to acknowledge the strong vested interests each of us has in the current structure. Tax complexity doesn't occur just because of "big money" special interests. It occurs because of the tax provisions that benefit each one of us. *We* are the special interests. And until we acknowledge that, tax reform discussions will deteriorate into shouting matches and fingerpointing about cutting "their" special tax breaks and not "ours."

The road to true tax reform requires each and every one to be willing to stop protecting our own tax breaks long enough to begin a dialogue about what we want our system to look like, so we remain a vibrant nation with a tax system that is transparent to its taxpayers—one that is simpler to understand and to comply with. If we want to run business incentives or social programs through that system, then we need to have a way to evaluate those programs so we can describe to the taxpayers what is being done and how effective those programs are.

As part of this dialogue about tax reform, we must remember why we have taxes in the first place: The federal government raises funds to provide protection and services to its citizens and residents primarily through taxes. We can all have different visions about the types and scope of government protection and services we want. But the fact is, without taxes, the government can do nothing for its citizens.

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So let us start this dialogue with the recognition that some level of taxation is necessary. As we continue that dialogue by discussing the structure of the tax system, let us also discuss the current tax system. By identifying aspects of the current system that cause complexity or excessive frustration, we can better design the new one.

Problem

The most serious problem facing taxpayers—and the IRS—is the complexity of the Internal Revenue Code.

IRS data show that when taxpayers have a choice about reporting their income, voluntary tax compliance rates are disturbingly low. Workers who are classified as employees have little opportunity to underreport their 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 non-farm sole proprietors report only 43 percent of their business income and unincorporated farming businesses report only 28 percent.

Tax 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, when 132 million tax returns were filed. This means that each taxpayer was effectively paying a "surtax" of some $2,200 to subsidize noncompliance by others. As the Administration and Congress assess our existing tax system, it is important to consider why tax compliance rates are so low among taxpayers whose income is not subject to withholding or reporting.

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

The IRS employs about 100,000 workers and generally performs very well, but it faces daunting challenges in running the tax system. Despite the fact that about 90 percent of taxpayers rely on preparers or tax software packages, the IRS received 110 million calls in each of the last two fiscal years. That is a staggering number, and not surprisingly, the IRS was unable to answer more than 25 percent of them. In fiscal year (FY) 2008, the IRS received approximately 167 million calls overall, largely inquiries generated by the Economic Stimulus Act, and was only able to answer 53 percent.

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

- 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).
- 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).
- The earned income tax credit ($268.8 billion).
- The deduction for nonbusiness state and local taxes ($237.3 billion).
- The exclusion of captain gains at death ($194.0 billion).
- The deduction for charitable contributions ($187.5 billion).

As this list illustrates, the big-ticket items do not benefit narrow special interests. They benefit large segments of the taxpaying public. Moreover, many of these tax breaks are designed to promote objectives that most taxpayers would consider desirable. The mortgage interest deduction is designed to promote home ownership. The employer exclusion for health care-related benefits is designed to encourage employers to provide health insurance coverage for their workers. The exclusion of retirement plan contributions is designed to encourage Americans to save for retirement. The EITC provides a credit for low income individuals who hold jobs, seeking to encourage work and raise them out of poverty. Finally, the deduction for charitable contributions is designed to encourage taxpayers to support charities and other nonprofit organizations that seek to advance the public good.

As the magnitude of the numbers suggests, however, tax expenditures have a huge impact on the public's attitude toward tax reform. 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. In practice, the prospect of lower rates may seem speculative and distant, while the threatened loss of existing tax breaks raises immediate concerns. Thus, taxpayers require some reassurance that the loss of their tax breaks will indeed be accompanied by a corresponding reduction in rates.

General Principles

Tax reform should be approached in a manner similar to zero-based budgeting. To start the discussion, the assumption should be that all tax expenditures would be eliminated. An expenditure would be added back only if a compelling business case can be made that the benefits of providing the tax incentive through the tax code outweigh the tax-complexity challenges that special rules create.

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.

We further recommend that the protection of taxpayer rights and minimization of taxpayer burden be given appropriate emphasis as a new tax framework is developed. Toward this end, we suggest six core principles that should help guide the development of tax reform legislation:

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 assistors 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.
5. Where the tax laws provide for refundable credits, they should be designed in a way that the IRS can effectively administer.
6. The tax system should incorporate a periodic review of the tax code—in short, a sanity check.

Simplification Proposals

Among specific simplification proposals the National Taxpayer Advocate has made in past reports are the following:

1. Repeal the Alternative Minimum Tax for individuals.
2. Consolidate the "family status" provisions (including filing status, personal and dependency exemptions, the child tax credit, the earned income tax credit, the child and dependent care credit, and the separated spouse rule under IRC § 7703(b)).
3. Improve other provisions that govern taxation of the family unit, including "joint and several liability" and the "kiddie tax."
4. Consolidate the incentives to encourage savings for education (there are now at least 11 separate incentives).
5. Consolidate the incentives to encourage savings for retirement (there are now at least 16 separate incentives).
6. Simplify the worker classification rules to reduce disputes over employee-vs.-independent contractor status.
7. Reduce procedural incentives to use tax sunsets (more than 100 provisions in the tax code are temporary and thus require periodic renewal).
8. Reduce income phase-outs, which affect more than half of all returns each year and add considerable complexity to tax computations.
9. Streamline the penalty regime for tax violations (there are now more than 130 penalty provisions, up from 14 in 1954).

Tax Reform Is Personal: We Must All "Give at the Office"

Overall, the Joint Committee on Taxation estimates that tax expenditures total about $1.1 trillion a year. As compared with about 138 million tax returns filed in 2010, that amounts to an average reduction in tax per return of about $8,000.

We are not advocating for a flat tax or recommending that all tax expenditures be terminated.

If tax reform is to gain traction, the key challenge will be to persuade taxpayers that they personally, and the system as a whole, will be better off if many targeted benefits are eliminated in favor of lowering tax rates for substantially all U.S. taxpayers.

As the statutory voice of the taxpayer, the National Taxpayer Advocate believes that tax reform is essential and urgent, but it must not be rushed. Tax reform should not be imposed on taxpayers. Rather, it should be shaped with taxpayer engagement and support.

Ultimately, taxpayer involvement will lead to a better result, and equally important, it will make taxpayers feel more connected with the end product, which could lead to compliance gains as well.

The key is that in conducting this dialogue, we must be honest. We cannot pretend that broadening the tax base means eliminating someone else's tax break while preserving our own. Everything must be put on the table, and we must make clear that, in exchange for lower rates, some tax breaks will be eliminated immediately and others will be phased out.

But it is equally important to make clear that, assuming revenue neutrality, the average taxpayer will not pay more tax and the tax code will be much easier to understand and comply with. Taxpayers would have a better understanding of how their tax liabilities are computed, would have more confidence that the system is treating them fairly relative to others, and would save time and money preparing their returns because they could do the job quickly themselves. ■

IRS NATIONWIDE TAX FORUMS

As a component of its communication and outreach efforts, the IRS is conducting a series of tax forums across the nation this summer. Designed for tax professionals, the forums present the latest news and information from the IRS over three days of seminars taught by experts from the IRS, the ABA Section of Taxation, and other national organizations.

The Forums are visiting the following cites this year:

Atlanta, GA	**June 28 – 30**
Orlando, FL	**July 12 – 14**
Dallas, TX	**July 26 – 28**
San Jose, CA	**August 9 – 11**
Las Vegas, NV	**August 16 – 18**
Washington, DC	**August 30 – September 1**

For more information and to register, visit www.irstaxforum.com. Fees are: $206 Pre-Registration; $196 Members of Partner Associations; $335 On-site or Late Registration. ABA members qualify for the Partner Association discount; please call the Tax Section office at 202/662-8670 for the discount code. Please note that CLE accreditation is not requested in advance for these programs, and attorneys interested in attending and earning CLE credit are encouraged to check with their state regulatory boards.