TAX REFORM: Simplify the Internal Revenue Code Now

PROBLEM

It has now been more than 30 years since Congress enacted the Tax Reform Act of 1986 to substantially simplify the tax code, and since that time, the code has grown more complex by the year, as evidenced by the fact that Congress has made more than 5,900 changes to the code — an average of more than one a day — just since 2001. The compliance burdens the tax code imposes on taxpayers and the IRS alike are overwhelming, and we urge Congress to act this year to vastly simplify it.

In prior reports, the National Taxpayer Advocate has designated the complexity of the tax code as the most serious problem facing taxpayers and has recommended general principles and specific areas for reform.¹ With an incoming Administration and Congress, we reiterate those recommendations in this report.

Among other things, the tax code:

- Makes compliance difficult, requiring taxpayers to devote excessive time to preparing and filing their returns;
- Requires the significant majority of taxpayers to bear monetary costs to comply, as most taxpayers hire preparers and many other taxpayers purchase tax preparation software;
- Rewards taxpayers who can afford expensive tax advice and discriminates against taxpayers who cannot;
- Undermines trust and confidence in the tax system, as many taxpayers do not understand how their taxes are computed or even what rate of tax they pay;
- Leads to lower levels of tax compliance, as taxpayers make high rates of both inadvertent and deliberate errors, and the complexity of tax returns limits the IRS’s ability to detect noncompliance through audits or other means; and
- Requires a large federal agency to administer the tax system, as the IRS must, among other things, publish forms and publications, create computer code for thousands of tax provisions, enforce the law, and respond to more than 100 million telephone calls, ten million letters, and five million visits from taxpayers every year.

In general, tax simplification would require Congress to pare back the number of income exclusions, exemptions, deductions, credits, and preferential tax rates (collectively known as “tax expenditures”). For fiscal year (FY) 2016, the Treasury Department projected that tax expenditures would come to about

$1.42 trillion.² As a point of comparison, total individual income tax revenue was projected to be about $1.63 trillion.³

**FIGURE 2.1.1**

Tax Expenditures vs. Individual Income Tax Revenue, FY 2016

![Graph showing Tax Expenditures vs. Individual Income Tax Revenue, FY 2016](image)

This suggests that if Congress were to eliminate all tax expenditures, it could cut individual income tax rates by about 47 percent and still generate about the same amount of revenue.⁴

This is the essence of comprehensive tax simplification. Tax expenditures would be substantially eliminated and the additional revenue would be used to substantially reduce tax rates, leaving the average taxpayer with about the same tax bill he or she has now – but with the ability to compute it much more simply and accurately.

We fully acknowledge that simplifying the tax code requires important policy trade-offs. To cite some well-known examples, Congress historically has allowed married couples and heads-of-households with children to claim larger standard deductions than single taxpayers, thus taxing them less on equivalent incomes. It has allowed a personal exemption for each taxpayer that participates in the filing of a joint return and a dependency exemption for each eligible child, again reflecting a social policy that taxes married couples and larger families less than single taxpayers and smaller families on equivalent incomes. In enacting the Earned Income Tax Credit (EITC), Congress on a bipartisan basis created a social benefits

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² See Office of Tax Analysis, U.S. Department of the Treasury, *Tax Expenditures* (Sept. 2016), https://www.treasury.gov/resource-center/tax-policy/Documents/Tax-Expenditures-FY2018.pdf. It should be noted that estimates of “tax expenditures” do not include the amount of tax revenue foregone due to the standard deduction and personal and dependency exemptions, even though those provisions reflect congressional policy decisions embedded in the tax code. If the revenue reductions associated with these provisions were taken into account, the total of tax expenditures estimates would be substantially greater than $1.42 trillion.


⁴ We cite this figure solely as a ballpark estimate. On the one hand, if all tax expenditures included in the Treasury Department’s and Joint Committee on Taxation’s estimates were repealed simultaneously, the additional revenue generated would probably be less than the sum total of tax expenditures because of interactive effects. On the other hand, if all tax expenditures were eliminated, the taxable income of many taxpayers would increase, moving some taxpayers into higher marginal tax-rate brackets and thereby increasing their tax liabilities. In addition, as noted above, estimates of “tax expenditures” do not include the amount of tax revenue foregone due to the standard deduction and personal and dependency exemptions, even though those provisions reflect congressional policy decisions embedded in the tax code. These totals are intended solely to paint a general portrait of the magnitude of tax expenditures. 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, 3 (Jan. 5, 2008) http://www.taxpolicycenter.org/publications/how-big-are-total-individual-income-tax-expenditures-and-who-benefits-them/full; 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”).
program styled as a work incentive, so that only taxpayers who work are eligible to receive program benefits.\textsuperscript{5} And on the business side, Congress has provided incentives for research, among other things. In fact, every provision in the tax code was enacted for a policy reason, and it is not likely Congress will choose to eliminate all tax expenditures, nor do we recommend that it do so.

However, we strongly recommend significant tax simplification, and to accomplish it, we recommend Congress use a “zero-based budgeting” approach. The starting point for discussion would be a tax code without any exclusions or reductions in income or tax. A tax break or IRS-administered social program would be added only if lawmakers decide, on balance, that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity burden that the provision creates for taxpayers and the IRS. At the end of the exercise, tax rates can be set at whatever level is required to raise the amount of revenue that Congress determines is appropriate.

In the event Congress determines comprehensive tax simplification is not feasible at this time, we also recommend below certain areas for limited tax simplification.

The Tax Code Imposes Onerous Compliance Burdens on Individual Taxpayers and Businesses

A few data points will illustrate the magnitude of the compliance burdens the tax code imposes on individuals and businesses:

- According to a TAS analysis of IRS data, individuals and businesses spend about six billion hours a year complying with the filing requirements of the Internal Revenue Code (IRC).\textsuperscript{6} And that figure does not include the millions of additional hours that taxpayers must spend when they are required to respond to IRS notices or audits.

\textsuperscript{5} See Legislative Recommendation: Tax Reform: Restructure the Earned Income Tax Credit and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden, infra.

\textsuperscript{6} The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for calendar year 2015 by the average amount of time the IRS estimated it took to complete the form. Except as noted below, tax return counts are calendar year 2015 estimated counts and come from IRS Document 6149, Table 1 – 2015 Update (revised Nov. 2015), http://www.irs.gov/pub/irs-soi/d6149.pdf. Information return counts are actual calendar year 2015 counts and come from IRS Document 6961, Table 2 – 2016 Update (revised July 2016), http://www.irs.gov/pub/irs-soi/d6961.pdf. Time burden estimates are listed in form instructions or, some cases, on the forms themselves. Additional notes: burden estimates for Form 8962, \textit{Premium Tax Credit} (PTC), and Form 8965, \textit{Health Coverage Exemption}, are included in the Form 1040 average; data for ACA information returns (Forms 1094-B, 1095-B, 1094-C, and 1095-C) and FATCA Forms 8966 and 8809-EX are currently not available; form counts for Forms 1065 and 1065B are from the Business Return Transaction File Form 1065 and Form 1065B tables on the Compliance Data Warehouse for returns filed during processing year 2015 (Nov. 2016); the time burden estimate for Forms 1120-L/ND/PC/REIT/SF is from the Form 1120-REIT to be conservative, as it had the lowest average of this form series; form counts for Forms 940 and 940A are from the Business Return Transaction File Form 940 and Form 940 Detail (Sch. A) table on the Compliance Data Warehouse for returns filed during processing year 2015 (Nov. 2016); and the form count for Form 8938 is from the Electronic Tax Administration Research and Analysis System (ETARAS) data table on the Compliance Data Warehouse for returns filed during processing year 2015 (Nov. 2016). While the IRS’s estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and, as noted in the text, it does not include the amount of time taxpayers spend responding to post-filing notices, examinations, or collection actions. Conversely, the TAS estimate may be high because IRS time estimates have not necessarily kept pace fully with technology improvements that allow a wider range of processing activities to be completed via automation.
## FIGURE 2.1.2, Hours Required to Prepare Tax Returns and Information Reporting Documents, Calendar Year 2015

<table>
<thead>
<tr>
<th>Type of Return</th>
<th>Number of Forms</th>
<th>Time Per Form (in hours)</th>
<th>Total Hours</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tax Returns</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Form 1040: U.S. Individual Income Tax Return</td>
<td>148,477,500</td>
<td>13</td>
<td>1,930,207,500.00</td>
</tr>
<tr>
<td>Form 1041: U.S. Income Tax Return for Estates and Trusts</td>
<td>3,238,800</td>
<td>89.47</td>
<td>289,775,436.00</td>
</tr>
<tr>
<td>Form 1041-ES: Estimated Income Tax for Estates and Trusts</td>
<td>671,200</td>
<td>2.28</td>
<td>1,530,336.00</td>
</tr>
<tr>
<td>Form 1065: U.S. Return of Partnership Income</td>
<td>3,748,283</td>
<td>93.15</td>
<td>349,152,561.45</td>
</tr>
<tr>
<td>Form 1065B: U.S. Return of Income for Electing Large Partnerships</td>
<td>85</td>
<td>153.30</td>
<td>13,030.50</td>
</tr>
<tr>
<td>Form 1120S: U.S. Income Tax Return for an S Corporation</td>
<td>4,759,100</td>
<td>155.38</td>
<td>739,468,958.00</td>
</tr>
<tr>
<td>Forms 1120/1120A: U.S. Corporation Income Tax Return</td>
<td>1,791,400</td>
<td>185.68</td>
<td>332,627,152.00</td>
</tr>
<tr>
<td>Form 1066: U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return</td>
<td>39,200</td>
<td>53.77</td>
<td>2,107,784.00</td>
</tr>
<tr>
<td>Form 1120-C: U.S. Income Tax Return for Cooperative Associations</td>
<td>8,900</td>
<td>111.85</td>
<td>995,465.00</td>
</tr>
<tr>
<td>Form 1120-F: U.S. Income Tax Return of a Foreign Corporation</td>
<td>44,200</td>
<td>185.45</td>
<td>8,196,890.00</td>
</tr>
<tr>
<td>Form 1120-H: U.S. Income Tax Return for Homeowners Associations</td>
<td>250,400</td>
<td>32.62</td>
<td>8,168,048.00</td>
</tr>
<tr>
<td>Form 1120 RIC: U.S. Income Tax Return for Regulated Investment Companies</td>
<td>16,700</td>
<td>116.93</td>
<td>1,952,731.00</td>
</tr>
<tr>
<td>Form 706: United States Estate (and Generation - Skipping Transfer) Tax Return</td>
<td>36,328</td>
<td>7.75</td>
<td>281,542.00</td>
</tr>
<tr>
<td>Form 709: United States Gift (and Generation - Shipping Transfer) Tax Return</td>
<td>277,500</td>
<td>6.15</td>
<td>1,706,625.00</td>
</tr>
<tr>
<td>Form 940: Employer’s Annual Federal Unemployment (FUTA) Tax Return</td>
<td>3,750,349</td>
<td>3.87</td>
<td>14,513,850.63</td>
</tr>
<tr>
<td>Form 940 Schedule A: Multi-State Employer and Credit Reduction Information</td>
<td>1,829,849</td>
<td>13.60</td>
<td>24,885,948.40</td>
</tr>
<tr>
<td>Form 941: Employer’s Quarterly Federal Tax Return</td>
<td>24,611,500</td>
<td>2.88</td>
<td>70,881,120.00</td>
</tr>
<tr>
<td>Form 990: Return of Organization Exempt from Income Tax</td>
<td>323,700</td>
<td>139.63</td>
<td>45,198,231.00</td>
</tr>
<tr>
<td>Form 990 EZ: Short Form Return of Organization Exempt from Income Tax</td>
<td>278,100</td>
<td>55.65</td>
<td>15,476,265.00</td>
</tr>
<tr>
<td>Form 990 PF: Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation</td>
<td>103,500</td>
<td>203.05</td>
<td>21,015,675.00</td>
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<tr>
<td>Form 990 T: Exempt Organization Business Income Tax Return (and proxy tax under section 6033(e))</td>
<td>180,700</td>
<td>141.80</td>
<td>25,623,260.00</td>
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<tr>
<td>Form 720: Quarterly Federal Excise Tax Return</td>
<td>205,200</td>
<td>57.52</td>
<td>11,803,104.00</td>
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<tr>
<td>Form 1040X: Amended U.S. Individual Income Tax Return</td>
<td>3,623,600</td>
<td>10.00</td>
<td>36,236,000.00</td>
</tr>
<tr>
<td>Form 8938: Statement of Specified Foreign Financial Assets</td>
<td>246,230</td>
<td>4.62</td>
<td>1,137,582.60</td>
</tr>
<tr>
<td>Form 5227: Split - Interest Trust Information Return</td>
<td>106,500</td>
<td>148.40</td>
<td>15,804,600.00</td>
</tr>
<tr>
<td>Form 943: Employer’s Annual Federal Tax Return for Agricultural Employees</td>
<td>196,600</td>
<td>11.95</td>
<td>2,349,370.00</td>
</tr>
<tr>
<td>Form 4720: Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code (Sections 170(f)(10), 664(c)(2), 4911, 4912, 4941, 4942, 4943, 4944, 4945, 4955, 4958, 4959, 4965, 4966, and 4967)</td>
<td>2,300</td>
<td>113.37</td>
<td>260,751.00</td>
</tr>
<tr>
<td>Form 5500 EZ: Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan</td>
<td>118,500</td>
<td>27.98</td>
<td>3,315,630.00</td>
</tr>
<tr>
<td>Form 2290: Heavy Highway Vehicle Use Tax Return</td>
<td>750,200</td>
<td>42.85</td>
<td>32,146,070.00</td>
</tr>
<tr>
<td>Form 8752: Required Payment or Refund Under Section 7519</td>
<td>29,200</td>
<td>7.85</td>
<td>229,220.00</td>
</tr>
<tr>
<td>Form 2553: Election by a Small Business Corporation</td>
<td>447,900</td>
<td>16.37</td>
<td>7,332,123.00</td>
</tr>
<tr>
<td>Form 7004: Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns</td>
<td>6,542,900</td>
<td>6.77</td>
<td>44,295,433.00</td>
</tr>
</tbody>
</table>

**Tax Returns Subtotal** 4,041,389,165.58
### FIGURE 2.1.2, Hours Required to Prepare Tax Returns and Information Reporting Documents, Calendar Year 2015 (continued)

<table>
<thead>
<tr>
<th>Type of Return</th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Information Returns</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Form W-2: Wage and Tax Statement</td>
<td>243,550,600</td>
<td>0.50</td>
<td>121,775,300.00</td>
</tr>
<tr>
<td>Form 1041 K-1: Beneficiary's Share of Income, Deductions, Credits, etc.</td>
<td>3,403,736</td>
<td>7.75</td>
<td>26,378,954.00</td>
</tr>
<tr>
<td>Form 1065 K-1: Partner's Share of Income, Deductions, Credits, etc.</td>
<td>29,931,317</td>
<td>28.22</td>
<td>844,661,765.74</td>
</tr>
<tr>
<td>Form 1120 S-K: Shareholder's Share of Income, Deductions, Credits, etc.</td>
<td>7,431,895</td>
<td>25.73</td>
<td>191,222,658.35</td>
</tr>
<tr>
<td>Form 1096: Annual Summary and Transmittal of U.S. Information Returns</td>
<td>5,422,293</td>
<td>0.22</td>
<td>1,192,904.46</td>
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<tr>
<td>Form 1098: Mortgage Interest Statement</td>
<td>81,132,333</td>
<td>0.12</td>
<td>9,735,879.96</td>
</tr>
<tr>
<td>Form 1098-C: Contributions of Motor Vehicles, Boats and Airplanes</td>
<td>123,011</td>
<td>0.30</td>
<td>36,903.30</td>
</tr>
<tr>
<td>Form 1098-E: Student Loan Interest Statement</td>
<td>21,966,235</td>
<td>0.12</td>
<td>2,635,948.20</td>
</tr>
<tr>
<td>Form 1098-T: Tuition Statement</td>
<td>26,156,848</td>
<td>0.22</td>
<td>5,754,506.56</td>
</tr>
<tr>
<td>Form 1099-A: Acquisition or Abandonment of Secured Property</td>
<td>628,993</td>
<td>0.15</td>
<td>94,348.95</td>
</tr>
<tr>
<td>Form 1099-B: Proceeds From Broker and Barter Exchange Transactions</td>
<td>1,434,809,803</td>
<td>0.33</td>
<td>478,269,934.33</td>
</tr>
<tr>
<td>Form 1099-C: Cancellation of Debt</td>
<td>6,364,769</td>
<td>0.22</td>
<td>1,400,249.18</td>
</tr>
<tr>
<td>Form 1099-D: Dividends and Distributions</td>
<td>87,281,753</td>
<td>0.38</td>
<td>33,167,066.14</td>
</tr>
<tr>
<td>Form 1099-G: Certain Government Payments</td>
<td>77,606,213</td>
<td>0.32</td>
<td>24,833,988.16</td>
</tr>
<tr>
<td>Form 1099-INT: Interest Income</td>
<td>143,367,656</td>
<td>0.22</td>
<td>31,062,992.13</td>
</tr>
<tr>
<td>Form 1099-K: Payment Card and Third Party Network Transactions</td>
<td>9,748,857</td>
<td>0.33</td>
<td>3,217,122.81</td>
</tr>
<tr>
<td>Form 1099-LTC: Long-Term Care and Accelerated Death Benefits</td>
<td>299,563</td>
<td>0.22</td>
<td>64,905.32</td>
</tr>
<tr>
<td>Form 1099-MISC: Miscellaneous Income</td>
<td>92,003,184</td>
<td>0.30</td>
<td>27,600,955.20</td>
</tr>
<tr>
<td>Form 1099-OID: Original Issue Discount</td>
<td>2,074,290</td>
<td>0.18</td>
<td>373,372.20</td>
</tr>
<tr>
<td>Form 1099-PAR: Taxable Distributions Received from Cooperatives</td>
<td>1,820,375</td>
<td>0.25</td>
<td>455,093.75</td>
</tr>
<tr>
<td>Form 1099-Q: Payments From Qualified Education Programs (Under Sections 529 and 530)</td>
<td>2,404,454</td>
<td>0.18</td>
<td>440,816.57</td>
</tr>
<tr>
<td>Form 1099-R: Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.</td>
<td>92,096,506</td>
<td>0.42</td>
<td>38,680,532.52</td>
</tr>
<tr>
<td>Form 1099-S: Proceeds From Real Estate Transactions</td>
<td>3,285,433</td>
<td>0.13</td>
<td>427,106.29</td>
</tr>
<tr>
<td>Form 1099-SA: Deductions From an HSA, Archer MSA, or Medicare Advantage MSA</td>
<td>8,063,576</td>
<td>0.15</td>
<td>1,209,536.40</td>
</tr>
<tr>
<td>Form 5498: IRA Contribution Information</td>
<td>120,105,028</td>
<td>0.40</td>
<td>48,042,011.20</td>
</tr>
<tr>
<td>Form 5498-ESA: Coverdell ESA Contribution Information</td>
<td>405,844</td>
<td>0.12</td>
<td>47,348.47</td>
</tr>
<tr>
<td>Form 5498-SA: HSA, Archer MSA, or Medicare Advantage MSA Information</td>
<td>10,752,553</td>
<td>0.17</td>
<td>1,792,092.17</td>
</tr>
<tr>
<td>Form 10425S: Foreign Person's U.S. Source Income Subject to Withholding</td>
<td>5,282,421</td>
<td>17.50</td>
<td>92,442,367.50</td>
</tr>
<tr>
<td>Form W2-G: Certain Gambling Winnings</td>
<td>11,415,379</td>
<td>0.33</td>
<td>3,767,075.07</td>
</tr>
<tr>
<td><strong>Information Returns Subtotal</strong></td>
<td></td>
<td></td>
<td>1,990,783,811.19</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td></td>
<td></td>
<td>6,032,172,976.77</td>
</tr>
</tbody>
</table>
If tax compliance were an industry, it would be one of the largest in the United States. To consume six billion hours, the “tax industry” requires the equivalent of three million full-time workers.\(^7\)

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 2015 amounted to $195 billion — or more than ten percent of aggregate income tax receipts.\(^8\)

**FIGURE 2.1.3**

Income Tax Compliance Costs vs. Tax Revenue, FY 2015

\[
\text{Income Tax Compliance Costs} \quad \text{\$195 billion}
\]

\[
\text{Tax Revenue}
\]

According to a tally compiled by a leading publisher of tax information, there have been almost 5,900 changes to the tax code since 2001, an average of more than one a day.\(^9\)

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\(^7\) 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).

\(^8\) The IRS and several outside analysts have attempted to quantify the costs of tax compliance. For an overview of some previous studies, see Government Accountability Office (GAO), GAO-05-878, Tax Policy: Summary of Estimates of the Costs of the Federal Tax System (Aug. 2005), http://www.gao.gov/new.items/d05878.pdf. There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the tax code. TAS estimated the cost of complying with personal and business income tax requirements (and thus excluding the time spent complying with employment, estate and gift, excise, and exempt organization tax requirements) by multiplying the total number of hours spent on income tax compliance (5.80 billion) by the average hourly cost of a civilian employee ($33.58), as reported by the Bureau of Labor Statistics. See Bureau of Labor Statistics, U.S. Department of Labor, Employee Costs for Employee Compensation – December 2015, USDL: 16-0463 (March 16, 2016) (including wages and benefits), www.bls.gov/news.release/archives/ecec_03102016.pdf. TAS estimated compliance costs as a percentage of total income tax receipts for 2015 by dividing the income tax compliance cost as computed above ($195 billion) by total 2015 income tax receipts ($1.88 trillion). See Office of Management and Budget, Budget of the United States Government, Historical Tables, Table 2-1, https://www.whitehouse.gov/sites/default/files/omb/budget/fy2017/assets/hist02z1.xls.

\(^9\) Unpublished data provided by Wolters Kluwer Tax & Accounting to TAS (Dec. 8, 2016). Wolters Kluwer notes there is some subjectivity in computing these numbers because the counts are tied to how legislation is written. In general, an “Act Finding List” lists every Act section (or portion thereof) in a given Public Law and the corresponding amendment(s) it makes to the Internal Revenue Code (IRC). For example, assume an Act adds three new sections to the IRC. If the Act contains three sections that each adds one Code section, Wolters Kluwer would count three Code changes. But if the Act contains one section that adds a new Part to the IRC and that Part, in turn, contains the same three new Code sections, Wolters Kluwer would count one Code change.
The tax code has grown so long that it has become challenging even to figure out how long it is. A search of the tax code conducted using the “word count” feature in Microsoft Word turned up nearly four million words.\(^\text{10}\)

Individual taxpayers find return preparation so overwhelming that the majority (54 percent at last count) pay preparers to do it for them.\(^\text{11}\) Among unincorporated business taxpayers, the figure rises to about 68 percent.\(^\text{12}\) Depending on the complexity of the return and other factors, return preparation fees typically range from several hundred dollars to several thousand dollars, and much more for complex businesses. Roughly an additional 40 percent of individual taxpayers use tax software to help them prepare their returns,\(^\text{13}\) with leading software packages typically costing $50 or more.\(^\text{14}\)

\(^{10}\) To determine the number of words in the IRC, TAS downloaded Title 26 of the U.S. Code (i.e., the Internal Revenue Code) from the website of the U.S. House of Representatives, http://uscode.house.gov. We copied the file into Microsoft Word, and used the “word count” feature to compute the number of words. The online version of Title 26 we used was current through December 12, 2016. In Word, the document ran 10,928 single-spaced pages. The printed code contains certain information that does not have the effect of law, such as a description of amendments that have been adopted, effective dates, cross references, and captions. The word count feature also counts page numbers, the table of contents, and the like. Therefore, our count somewhat overstates the number of words that are officially considered a part of the tax code, although as a practical matter, a person seeking to determine the law will likely have to read and consider many of these additional words, including effective dates, cross references, and captions. Other attempts to determine the length of the Code may have excluded some or all of these components, but there is no clearly correct methodology to use, and we found no easy way to selectively delete information from a document of this length.

\(^{11}\) IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2014).

\(^{12}\) Id.

\(^{13}\) Id.

The federal government “spends” more money through the tax code each year than it spends to fund the entire federal government through the appropriations process. In FY 2016, as noted above, the Treasury Department estimated “tax expenditures” amounted to more than $1.4 trillion. At the same time, discretionary appropriations amounted to less than $1.2 trillion.

**FIGURE 2.1.5**

**Federal Appropriations vs. Tax Expenditures, FY 2016**

- Federal Appropriations: $1.2 trillion
- Tax Expenditures

**Complexity Helps Taxpayers Who Can Afford Expensive Tax Advice and Discriminates Against Taxpayers Who Cannot**

In general, completion of a tax return requires (i) listing gross income (or gross receipts for a business), (ii) claiming various tax benefits like deductions and credits, and (iii) subtracting the value of the tax benefits from gross income (or gross receipts) to arrive at “taxable income.”

The existing tax code contains more than 200 tax benefits that potentially may be claimed by individuals and businesses. Few, if any, taxpayers are familiar with all these benefits, and most preparers are not familiar with all of them as well. As a result, sophisticated taxpayers (or taxpayers who can afford to...
hire sophisticated tax advisors) are likely to claim most benefits for which they are eligible, while less sophisticated taxpayers often will miss them. A few examples will illustrate missed benefits:

**Standard Deduction vs. Itemized Deductions**

Individual taxpayers have a choice between claiming a standard deduction and itemizing their deductions, and may elect whichever one reduces their tax bill the most. Yet taxpayers who would pay less tax by itemizing sometimes fail to do so. Although somewhat dated, the Government Accountability Office (GAO) conducted a study of 1998 tax returns specifically on this point. It found that almost one million taxpayers did not itemize their deductions despite having made payments for mortgage interest and points and for state and local income tax that exceeded the amount of the standard deduction for their filing status. The GAO also imputed charitable contributions, real estate taxes, and personal property taxes and concluded that as many as 2.2 million taxpayers who claimed the standard deduction may have shortchanged themselves by failing to itemize.18

**Telephone Excise Tax Credit**

In 2006, taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government had improperly collected.19 The credit ranged from $30 to $60, depending on the number of personal 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

**Paid Preparer Errors**

While most taxpayers pay professionals to prepare their returns for them, using a paid preparer is not a guarantee of accuracy. In a 2006 GAO study, auditors posing as taxpayers made undercover visits to unenrolled tax return preparers and had 19 tax returns prepared under two relatively simple fact patterns.22 The GAO concluded the preparers made errors on every return. The tax liability the preparers computed ranged from underpaying tax by almost $2,000 to overpaying tax by more than $1,500. In two cases, preparers claimed the standard deduction on returns where itemizing deductions would have been more advantageous to the taxpayer. These were simple fact patterns that did not involve high income amounts, so the mistakes were significant in relative terms. With a simpler tax code, instances of overclaims and underclaims resulting from code complexity would decline.

The tax liability of an individual or a business should depend solely on how much is owed under the law — not on the taxpayer’s or preparer’s expertise in the law. A simpler tax code would go a long way toward solving this problem and ensuring that similarly situated taxpayers pay the same tax.

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19 See IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this section that are statutory, 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 long-distance telephone services at issue were not subject to taxation.


21 IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008). One might assume that tax return preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit. Id.


No one wants to feel like a “tax chump” – paying more while suspecting that others are taking advantage of loopholes to pay less. Yet the complexity of the tax code and the sense that other taxpayers are able to take advantage of “loopholes” makes many taxpayers feel as though they are overpaying. In a 2012 taxpayer survey conducted for TAS, 73 percent of respondents said “[t]he wealthy have ways of minimizing their Federal taxes that are not available to the average taxpayer” and only 12 percent said, “everyone pays their fair share of taxes.”\(^\text{23}\) Taxpayers who believe they are unfairly paying more than others inevitably will feel more justified in “fudging” to right the perceived wrong. Transparency is a critical feature of a successful tax system and is essential if the system is to build taxpayer confidence and maintain high rates of tax compliance. Simplifying the tax code so tax policy choices and computations are more transparent would help reassure taxpayers that the system is not rigged against them.

In this connection, there is a second element of transparency that we recommend Congress consider. Just as we believe taxpayers will place greater trust in the system if they understand how they are taxed, we believe taxpayers will place greater trust in the system if they understand how their tax dollars are spent. We have recommended that Congress direct the IRS to provide all taxpayers with a “taxpayer receipt” showing this.\(^\text{24}\) A “taxpayer receipt” could be a more detailed version of the pie chart currently published by the IRS,\(^\text{25}\) but it should be provided directly to each taxpayer in connection with the filing of a tax return.\(^\text{26}\) Better public awareness of the connection between taxes and government spending has the potential to improve civic morale, increase tax compliance, and make the national dialogue over looming fiscal policy choices more productive as well.

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

The IRS employs some 78,000 full-time workers and performs many of its tasks very well.\(^\text{27}\) However, it faces daunting challenges in administering the current tax code. This report catalogs many of them. Two key indicators of taxpayer service are the IRS’s ability to answer taxpayer telephone calls and the IRS’s ability to respond to taxpayer correspondence.\(^\text{28}\)


\(^{24}\) See National Taxpayer Advocate 2010 Annual Report to Congress 368 (Legislative Recommendation: Enact Tax Reform Now).

\(^{25}\) IRC § 7523 requires the IRS to include pie-shaped graphs showing the relative sizes of major outlay categories and major income categories in its instructions for Forms 1040, 1040A, and 1040EZ. See IRS Form 1040 Instructions (2016 revision covering Tax Year 2015), at 101.

\(^{26}\) In April 2011, the White House website launched a calculator titled “Your Federal Taxpayer Receipt” that allows taxpayers to enter the actual or estimated amounts of their Social Security, Medicare, and income tax payments and see a breakdown showing how their payments are being applied to major categories of federal spending, including Social Security, Medicare, national defense, health care, job and family security programs, interest on the national debt, Veterans benefits, and education. But it appears the calculator was last updated for 2014. See https://www.whitehouse.gov/21stcenturygov/tools/tax-receipt (last visited Dec. 13, 2016). Moreover, while we view the availability of this calculator as a positive development, most taxpayers will not take the time to visit this website. We therefore believe a taxpayer receipt should be provided in connection with the filing of a return.

\(^{27}\) The IRS had an average of 77,924 full-time equivalent employees in FY 2016 — almost 17,000 fewer employees than in FY 2011, a reduction of 18 percent. FY 2016 data provided by IRS Chief Financial Officer, Corporate Budget. FY 2011 data reported in IRS Data Book, 2011, Table 30, http://www.irs.gov/pub/irs-soi/11databk.pdf.

\(^{28}\) For a more detailed description of IRS workload and how well the IRS is assisting taxpayers and protecting taxpayer rights, see Taxpayer Rights Assessment: IRS Performance Measures and Data Relating to Taxpayer Rights, just after the Preface to this report, supra.
**Telephone Calls**

Despite the fact that more than 90 percent of individual taxpayers rely on preparers or tax software packages, the IRS has received more than 100 million calls in every year since 2008.\(^{29}\) That is a staggering volume of calls, and not surprisingly, the IRS has trouble answering them. In fact, the problem is growing worse. The IRS reached a high-water mark in providing taxpayer service in FY 2004. Comparing FY 2004 with FY 2016, the number of calls the IRS received from taxpayers on its Accounts Management telephone lines increased from 71 million to 104 million, yet the number of calls answered by telephone assistors declined from 36 million to 26 million.\(^ {30}\) The IRS has increased its ability to handle taxpayer calls using automation, but even so, the percentage of calls from taxpayers seeking to speak with a telephone assistor that the IRS answered dropped from 87 percent to 53 percent over the period.\(^ {31}\) And among the callers who got through, the average time spent waiting on hold increased from just over 2.5 minutes in FY 2004 to nearly 18 minutes in FY 2016.\(^ {32}\)

**Taxpayer Correspondence**

Over the same FY 2004 through FY 2016 period, the IRS’s ability to timely process taxpayer correspondence also declined. In most years from FY 2004 through FY 2012, the IRS received about ten million letters from taxpayers responding to IRS adjustment notices.\(^ {33}\) Because of declining resources, the

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\(^{29}\) IRS, Joint Operations Center, Snapshot Reports: Enterprise Snapshot (final week of each fiscal year for FY 2008 through FY 2016).

\(^{30}\) Compare IRS, Joint Operations Center, Snapshot Reports: Enterprise Snapshot (week ending Sept. 30, 2016) with IRS, Joint Operations Center, Snapshot Reports: Enterprise Snapshot (week ending Sept. 30, 2004). The Accounts Management telephone lines (previously known as the Customer Account Services telephone lines) receive the significant majority of taxpayer calls. However, taxpayer calls to compliance phone lines and certain other categories of calls are excluded from this total.

\(^{31}\) Id.

\(^{32}\) Id.

\(^{33}\) See, e.g., IRS, Joint Operations Center, CAS Accounts Management Paper Inventory Reports (July-September Fiscal Year Comparison for each fiscal year 2004 through 2012).
IRS has initiated fewer adjustments over the last few years. In FY 2016, it received only about 7.8 million letters, yet compared with FY 2004, the backlog of taxpayer correspondence in the tax adjustments inventory increased by 93 percent (from 357,151 to 690,460 pieces), and the percentage of taxpayer correspondence classified as “overage” jumped by 221 percent (from 11.5 percent to 36.9 percent).34

**FIGURE 2.1.7**

**IRS Adjustments Correspondence Inventory and Overaged Processing Statistics**  
**End of Fiscal Years 2004-2016**

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

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.

**Tax Simplification Requires Difficult Policy Trade-Offs**

In theory, almost everyone supports comprehensive tax simplification. But there is a reason Congress has not simplified the tax code since 1986. The vast majority of tax expenditures in the code benefit the vast majority of U.S. taxpayers, and it is difficult to take benefits away.

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

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34 Compare IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Oct. 1, 2016) with IRS, Joint Operations Center, *Weekly Enterprise Adjustments Inventory Report* (week ending Sept. 25, 2004). The Weekly Enterprise Adjustments Inventory Reports cover a period ending on a Saturday. For each year, we use data from the period ending on the Saturday closest to Sept. 30 (the end of the fiscal year), as reported on the IRS system.
loophole may be another taxpayer’s lifeline, and vice versa. The significant majority of tax expenditures benefit the masses.

For FY 2016, as described above, the Treasury Department has estimated that total income tax expenditures will come to about $1.42 trillion. The following tax expenditures account for almost 80 percent of this total:

**FIGURE 2.1.8, Major Federal Tax Expenditures, FY 2016**

<table>
<thead>
<tr>
<th>Major Federal Tax Expenditures, FY 2016</th>
<th>Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exclusion of Employer Contributions for Medical Insurance Premiums and Medical Care</td>
<td>$210.2 billion</td>
</tr>
<tr>
<td>Exclusion for Retirement Plan Contributions and Earnings</td>
<td>$177.9 billion</td>
</tr>
<tr>
<td>Reduced Rates of Tax on Long-Term Capital Gains and Dividends</td>
<td>$137.5 billion</td>
</tr>
<tr>
<td>Exclusion of Net Imputed Rental Income</td>
<td>$105.6 billion</td>
</tr>
<tr>
<td>Deferral of Income From Controlled Foreign Corporations</td>
<td>$102.1 billion</td>
</tr>
<tr>
<td>Mortgage Interest Deduction on Owner-Occupied Housing</td>
<td>$61.2 billion</td>
</tr>
<tr>
<td>Deduction for Nonbusiness State and Local Taxes (Except Property Taxes on Owner-Occupied Homes)</td>
<td>$56.2 billion</td>
</tr>
<tr>
<td>Step-Up in Basis of Capital Gains at Death</td>
<td>$50.0 billion</td>
</tr>
<tr>
<td>Exclusion of Social Security and Veterans’ Benefits</td>
<td>$44.9 billion</td>
</tr>
<tr>
<td>Accelerated Depreciation of Machinery and Equipment</td>
<td>$44.6 billion</td>
</tr>
<tr>
<td>Deduction for Charitable Contributions</td>
<td>$44.1 billion</td>
</tr>
<tr>
<td>Exclusion of Capital Gains on Home Sales</td>
<td>$43.3 billion</td>
</tr>
<tr>
<td>Deduction for State and Local Property Taxes on Owner-Occupied Homes</td>
<td>$34.5 billion</td>
</tr>
</tbody>
</table>

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

As this list makes clear, most tax expenditures are designed to advance policy goals. For example, the employer exclusion for medical insurance premiums and medical care is designed to encourage employers to provide health insurance coverage for their employees. The tax breaks for retirement plan contributions and earnings, such as through Section 401(k) plans and Individual Retirement Accounts (IRAs), are designed to encourage retirement savings. The deduction for charitable contributions is designed to encourage greater financial support for nonprofit organizations. The deduction for mortgage

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35 See Office of Tax Analysis, U.S. Department of the Treasury, *Tax Expenditures* (Sept. 2016), https://www.treasury.gov/resource-center/tax-policy/Documents/TaxExpenditures-FY2018.pdf. The Joint Committee on Taxation also makes estimates of tax expenditures, and for FY 2016, it projected total tax expenditures of $1.33 trillion. See Staff of the Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2015-2019* (Joint Comm. Print 2015), https://www.jct.gov/publications.html?func=startdown&id=4857. In the table that follows, “Exclusion for Retirement Plan Contributions and Earnings” represents the sum of exclusions from income for Section 401(k)-type plans ($61.8 billion), employer plans ($70.4 billion), Individual Retirement Accounts ($16.4 billion), and self-employed plans (sometimes known as “Keogh” plans) ($28.1 billion), and the low and moderate income savers credit ($1.3 billion); “Reduced Rates of Tax on Long-Term Capital Gains and Dividends” represents the sum of the reduced rates of tax on capital gains ($109.5 billion) and the reduced rates of tax on qualified dividends ($28.0 billion); and “Exclusion of Social Security and Veterans’ Benefits” represents the sum of exclusions from income of Social Security benefits ($36.1 billion) and Veterans’ benefits ($8.8 billion).
interest is designed to encourage home ownership. The elimination of these benefits could have undesirable effects — less health insurance, less retirement savings, smaller charitable contributions, and less home ownership.

From time to time, we read about tax breaks in the code that, at least at first blush, may seem unnecessary or wasteful. But they may serve important policy objectives upon closer review, and in any event, repealing a few isolated tax breaks will have little impact on the big picture. To substantially simplify the tax code, there is no way around eliminating many of the tax expenditures described above.

RECOMMENDATIONS

1. **From a Tax Administrative Perspective, Comprehensive Tax Simplification Is the Best Answer**

Despite these challenges, the National Taxpayer Advocate strongly supports comprehensive tax simplification. We believe that taxpayers will support tax reform by wide margins if they better understand the trade-offs involved and can be part of an informed dialogue. If tax reform is enacted on a revenue-neutral basis, the average taxpayer’s bill will not go up, and taxpayers will be much happier to have a simpler and more transparent system. 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 have their returns prepared.

A simple example illustrates why. Assume a taxpayer earns $60,000 and Congress determines he should pay federal income tax of $9,000. At the extremes, there are two possible approaches to arrive at that tax amount. One is to impose a flat tax on his entire $60,000 income at a rate of 15 percent. A second approach is to make available a menu of tax deductions, credits, and other benefits such that, if the taxpayer knows about all of them and properly claims them, his taxable income will fall to about $30,000 and will then be taxed at a rate of 30 percent. Both approaches yield the same tax. The first is straightforward and can be computed without detailed knowledge of the tax law or the need to seek assistance from a preparer, while the second approach requires the taxpayer or preparer to know about, and claim, all available tax benefits or end up overpaying.

As discussed above, a pure flat tax is probably unrealistic because, for example, there is a longstanding bipartisan consensus to tax married couples and families less than single workers, to provide tax incentives to encourage home ownership and charitable giving, to provide social welfare via the EITC as a way of making benefits contingent on work, and for businesses, to encourage research activities.

However, a substantially flatter tax would be simpler for taxpayers, would reduce the “tax industry” substantially, and would probably lead to a reduction in the size of the IRS as well, as taxpayers would require less guidance in return preparation and audits would be more straightforward.

To build public support for tax reform, policymakers must first lay the necessary groundwork. Whenever proposals to reduce tax expenditures are made, affected groups and industries typically mobilize quickly to oppose them. It is therefore important that the taxpaying public understand tax reform requires trade-offs between tax rates and tax breaks. An uninformed taxpayer who hears he may lose a tax break will instinctively want to keep it to prevent his tax bill from rising. An informed taxpayer who understands her tax bill will remain the same because tax rates will be lowered will have a very different reaction. The Tax Reform Act of 1986 was the last major revision of the tax code that followed this model, and despite
considerable initial concerns, taxpayers and Members of Congress came around.36 On the final votes, the Act was supported by significant bipartisan majorities in both the House and the Senate.37

Reforming the tax code requires consideration and balancing of several public goals, including fairness and economic efficiency. The National Taxpayer Advocate does not take a position on these broad policy issues. But viewing the tax code strictly from the perspective of minimizing taxpayer burden, there is no doubt: Simpler is better!

2. Congress Should Utilize a “Zero-Based Budgeting” Approach and Apply a Set of Core Principles in Approaching Tax Reform

Because it is highly unlikely Congress will eliminate all tax expenditures, it is important to establish a process for determining which tax expenditures to retain and which to repeal.

We offer two suggestions. First, we recommend that Congress approach tax reform in a manner similar to zero-based budgeting. Under that approach, the starting point would be a tax code without any exclusions or reductions in income or tax. As discussions proceed, tax breaks and IRS-administered social programs would be added only if lawmakers decide on balance that the public policy benefits of running the provision or program through the tax code outweigh the tax complexity challenges that doing so creates for taxpayers and the IRS. 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 or another approach for achieving that purpose.38

In addition to suggesting a zero-based budgeting approach to tax reform, we believe the protection of taxpayer rights and minimization of taxpayer burden should be emphasized, along with the IRS’s ability to administer the law. Toward those ends, we have suggested 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.

37 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, JCS-10-87, General Explanation of the Tax Reform Act of 1986 at 4 (May 1987), http://www.jct.gov/jcs-10-87.pdf.
38 When Congress wishes to spend money, it may do so in either of two ways. It can make expenditures directly via cash outlays, or it can make expenditures by providing tax breaks through the tax code. As a practical matter, a tax expenditure has the same impact as a government spending program. To illustrate, assume that an individual facing a 25 percent tax rate pays $10,000 in mortgage interest and that the government wants to provide a subsidy for home ownership. It could accomplish this objective in two ways: (1) it could allow the taxpayer to deduct the $10,000 of mortgage interest from his gross income, which would produce a tax reduction of $2,500, or (2) it could make a direct payment of $2,500 to the taxpayer in lieu of the tax deduction. The taxpayer ends up in the same economic position either way. For a detailed discussion of tax expenditures, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (Evaluate the Administration of Tax Expenditures). In addition, the National Taxpayer Advocate has previously discussed design elements that should be considered when running social benefit programs through the tax code. See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75-104 (Running Social Programs through the Tax System).
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.39

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

Over the past 15 years, the National Taxpayer Advocate has made numerous proposals to simplify various sections or areas of the tax code. While we hope comprehensive simplification is enacted, we offer this list of proposals in the event Congress decides to take a more limited approach to tax reform.

Repeal the Alternative Minimum Tax (AMT) for Individuals40

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). The AMT rules disallow those deductions. The AMT computations are also extremely burdensome. The National Taxpayer Advocate has repeatedly recommended that the AMT be repealed. Moreover, we note that if tax expenditures are substantially reduced, the AMT would be rendered largely irrelevant.41

Consolidate the Family Status Provisions

Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004,42 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 earned income tax credit, 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

39 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), http://govinfo.library.unt.edu/taxreformpanel/meetings/docs/olson_03032005.ppt. For more detail, see National Taxpayer Advocate 2005 Annual Report to Congress 375-380 (Key Legislative Recommendation: A Taxpayer-Centric Approach to Tax Reform).
40 See IRC §§ 55-59.
41 Since 2001, the National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in her reports and in congressional testimony. See National Taxpayer Advocate 2013 Annual Report to Congress 292-301 (Legislative Recommendation: Repeal the Alternative Minimum Tax); National Taxpayer Advocate 2008 Annual Report to Congress 356-62 (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 383-85 (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 166-77 (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).
home — are difficult for the IRS to verify without conducting audits into taxpayers’ personal and private lives. The National Taxpayer Advocate has recommended that, as part of a comprehensive reform of the tax code’s tax treatment of families, Congress consolidate the numerous existing family status-related provisions into two categories: (1) a Family Credit and (2) a Worker Credit. The refundable Family Credit would reflect the costs of maintaining a household and raising a family, while the refundable Worker Credit would provide an incentive and subsidy for low income individuals to work. She reiterates and expands upon her prior recommendation in this Report.43

**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.44 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.45 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.46

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.47 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. To reduce the compliance burden these rules impose while retaining their purpose, 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.48

43 See Legislative Recommendation: Tax Reform: Restructure the Earned Income Tax Credit (EITC) and Related Family Status Provisions to Improve Compliance and Minimize Taxpayer Burden, infra; National Taxpayer Advocate 2012 Annual Report to Congress 508-12 (Legislative Recommendation: Simplify the National Status and Related Requirements for Qualifying Children) and 513-20 (Legislative Recommendation: Amend IRC § 7703(b) to Remove the Household Maintenance Requirement and to Permit Taxpayers Living Apart on the Last Day of the Tax Year Who Have Legally Binding Separation Agreements to Be Considered “Not Married”). See also National Taxpayer Advocate 2008 Annual Report to Congress 363-69 (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).

44 IRC § 6013(d)(3).

45 IRC §§ 66 & 6015.

46 See National Taxpayer Advocate 2005 Annual Report to Congress 407-32 (Legislative Recommendation: Another Marriage Penalty: Taxing the Wrong Spouse); see also National Taxpayer Advocate 2001 Annual Report to Congress 128-65 (Legislative Recommendation: Joint and Several Liability).

47 IRC § 1(g).

48 See National Taxpayer Advocate 2002 Annual Report to Congress 231-42 (Legislative Recommendation: Children’s Income).
**Consolidate Education Savings Tax Incentives**

The tax code contains at least 12 separate incentives to encourage taxpayers to save for and spend on education.\(^49\) 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.\(^50\)

**Consolidate Retirement Savings Tax Incentives**

The tax code contains at least 15 separate incentives to encourage taxpayers to save for retirement.\(^51\) These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education savings incentives, the large number of retirement savings options and the lack of common definitions and terms can prevent taxpayers from making wise choices or understanding how each incentive works. The National Taxpayer Advocate has recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement savings option for self-employed taxpayers, one for plans offered by small businesses, and one suitable for plans offered by large businesses and governmental entities (eliminating types of plans that can be used solely by governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.\(^52\)

**Simplify Worker Classification Determinations to Minimize Employee-Versus-Independent Contractor Disputes**

The complexity and ambiguities in the existing worker classification rules create uncertainty for businesses and workers and lead to noncompliance. In general, businesses are required to pay and withhold employment tax, withhold income tax, and provide benefits only with respect to employees. Consequently, businesses have an incentive to classify workers as independent contractors to reduce their costs. Some workers seeking to avoid their tax obligations may also prefer to be classified as contractors if the business does not withhold taxes or report the payments to the IRS. On the other hand, workers classified as employees generally qualify for benefits that contractors do not.

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50. See National Taxpayer Advocate 2008 Annual Report to Congress 370-72 (Legislative Recommendation: *Simplify and Streamline Education Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 403-22 (Legislative Recommendation: *Simplification of Provisions to Encourage Education*).
52. See National Taxpayer Advocate 2008 Annual Report to Congress 373-74 (Legislative Recommendation: *Simplify and Streamline Retirement Savings Tax Incentives*); National Taxpayer Advocate 2004 Annual Report to Congress 423-32 (Legislative Recommendation: *Simplification of Provisions to Encourage Retirement Savings*).
Whether a worker should be classified as an employee or an independent contractor depends on a variety of factors that reflect the nature of the relationship between the worker and the business. The National Taxpayer Advocate has recommended that Congress:

1. Replace § 530 of the Revenue Act of 1978 with a provision applicable to both employment and income taxes, and require that the IRS consult with affected industries and report back to the tax-writing committees on the findings of its consultations, with the ultimate goal that the Secretary issue guidance based on these findings, including guidance with specific industry focus;

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.

Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets

The tax code contains at least 71 provisions that are scheduled to expire between 2016 and 2025. Tax benefits have increasingly been enacted for a limited number of years to reduce their cost for budget-scoring purposes and are then frequently “extended,” often after they have expired and on a retroactive basis. Thus, tax sunsets make it difficult for both the government and taxpayers to plan, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and possibly 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.

Eliminate (or Simplify) Phase-Outs

Roughly half of all individual income tax returns filed each year are affected by the gradual phase-out of certain tax benefits as a taxpayer’s income increases. These include personal and dependency exemptions and itemized deductions. There are 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

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53 See IRS Pub. 1779, Independent Contractor or Employee (2012).
55 The National Taxpayer Advocate’s initial recommendation was simply to require that the Secretary issue guidance. Based on subsequent discussions with small business groups, the National Taxpayer Advocate revised the recommendation to suggest that Congress first direct the IRS to hold a series of consultations with affected industries and report back to the tax-writing committees on its findings.
56 See National Taxpayer Advocate 2008 Annual Report to Congress 375-90 (Legislative Recommendation: Worker Classification).
58 See National Taxpayer Advocate 2008 Annual Report to Congress 397-409 (Legislative Recommendation: Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets).
59 For Tax Year 2006, about 70 million out of a total of about 138 million filed returns were affected by income-based phase-outs. IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2006). We have not subsequently re-computed the number of returns affected by phase-outs, but we are not aware of any changes in law that would significantly affect the proportion of affected returns.
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 they are necessary to accomplish their intended objective.60

Streamline the Penalty Regime
The number of civil tax penalties has increased from about 14 in 1955 to more than 170 today.61 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, without the kind of careful analysis conducted in 1989. The National
Taxpayer Advocate has recommended that Congress direct the IRS to (1) collect and analyze more
detailed penalty data on a regular basis and (2) conduct an empirical study to quantify the effect of each
penalty on voluntary compliance. Congress should appropriate additional funds for this research, as
necessary. In the meantime, based on penalty reform principles identified in 1989, the National Taxpayer
Advocate has recommended 11 steps that could be taken immediately.62

CONCLUSION
For the reasons described above, we believe that comprehensive tax simplification should be made a
priority. A simpler, more transparent tax code will substantially reduce the estimated six billion hours and
$195 billion that taxpayers spend on income tax return preparation; reduce the disparity in tax liabilities
between sophisticated or well advised taxpayers and other taxpayers; enable taxpayers to understand
how their tax liabilities are computed and prepare their own returns; improve taxpayer morale and tax
compliance, including the level of connection that taxpayers feel with the government; and enable the IRS
to administer the tax system more effectively and better meet taxpayer needs.

Based on all the comments we receive every year in the Taxpayer Advocate Service and our experience in
handling hundreds of thousands of taxpayer cases a year, we believe that lowering rates in exchange for
broadening the tax base would be an excellent bargain for U.S. taxpayers.

60 See National Taxpayer Advocate 2008 Annual Report to Congress 410-13 (Legislative Recommendation: Eliminate (or Simplify)
Phase-outs).
61 IRM 20.1.1.1.1, Background (Nov. 25, 2011) (stating that there were 14 civil penalties in 1955); IRS response to TAS
information request (July 10, 2014) (stating that the Office of Servicewide Penalties is charged with “administering more than
170 different civil penalties”).
62 See National Taxpayer Advocate 2008 Annual Report to Congress 414-18 (Legislative Recommendation: Reforming the Penalty
Regime), and vol. 2, at 1-45 (Research Study: A Framework for Reforming the Penalty Regime).