WRITTEN STATEMENT OF

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HEARING ON

COMPLEXITY AND THE TAX GAP: MAKING TAX COMPLIANCE EASIER AND COLLECTING WHAT’S DUE

BEFORE THE

COMMITTEE ON FINANCE
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Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

Thank you for inviting me to testify today about complexity and the tax gap.¹ In this statement, I will make the following points:

1. Most people pay their taxes voluntarily – the IRS collects only about three percent of tax revenue as a direct result of enforcement actions.

2. A significant amount of noncompliance results from inadvertent errors.

3. The causes of noncompliance vary, but simplifying the tax code could address many of them.

4. The current tax code imposes excessive compliance burdens, and is filled with special tax breaks and complicated tax rules of general applicability.

5. Complexity begets more complexity, burden, and noncompliance, as it creates opportunities for abuse, which in turn spur more complex legislation that may alienate taxpayers.

6. When complexity creates opportunities for abuse, an excessive reliance on enforcement to address the abuse often burdens and alienates taxpayers who are trying to comply.

7. The IRS’s failure to offer simple and reasonable payment alternatives to taxpayers who cannot pay in full leaves delinquencies uncollected and burdens and alienates those who are trying to comply.

8. Complexity promotes noncompliance and contributes to the tax gap, and specific areas need simplification with or without comprehensive tax reform.

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. However, the National Taxpayer Advocate presents an independent taxpayer perspective that does not necessarily reflect the position of the IRS, the Treasury Department, or the Office of Management and Budget. Congressional testimony requested from the National Taxpayer Advocate is not submitted to the IRS, the Treasury Department, or the Office of Management and Budget for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.
I. Most People Pay Their Taxes Voluntarily – The IRS Collects Only About Three Percent of Tax Revenue as a Direct Result of Enforcement Actions.

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. For this reason, it is important to reduce the tax gap.

The only realistic way to reduce the tax gap is by increasing voluntary tax compliance. According to the latest IRS estimates, taxpayers paid about 83.7 percent ($1.767 trillion of the $2.112 trillion due) voluntarily and timely in 2001, and the IRS will eventually collect another 3 percent ($55 billion out of $2.112 trillion) through late payments or enforcement. In other words, taxpayers voluntarily and timely pay about 32 times as much as the IRS collects through enforcement and voluntary late payments. Similarly, of the $2.3 trillion in tax revenue received by the IRS in FY 2010, direct enforcement revenue accounted for only $57.6 billion, or about 3 percent. The remaining 97 percent resulted from voluntary compliance, though this includes some voluntary compliance that indirectly results from enforcement. Accordingly, trying to reduce the tax gap by focusing narrowly on increasing the 3 percent of revenue that results from enforcement while ignoring the 97 percent that results from voluntary compliance is a bit like letting the tail wag the dog. Moreover, such a focus can lead to reactionary laws, procedures, and enforcement actions that actually reduce overall revenue, particularly if they do not address the reasons for the noncompliance or if they unnecessarily burden or alienate the vast majority of taxpayers who are trying to comply.

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3 IRS, Compliance Data Warehouse (CDW), Individual Returns Transaction File (IRTF) (June 17, 2011) (indicating that 132 million tax returns were filed for tax year 2001).

4 IRS, Tax Gap Map for Year 2001 (Feb. 2007).

5 For example, if the IRS could collect one percent more through a collection strategy that would reduce voluntary compliance by one percent, overall revenues would decline by 32 times as much as collections increased. However, because the IRS collection function does not measure its impact on voluntary compliance, IRS collection metrics would not alert anyone to a problem.

II. A Significant Amount of Noncompliance Results from Inadvertent Errors.

A. IRS Data Do Not Rule Out the Possibility that Most Noncompliance Results from Inadvertent Errors.

The IRS attempted to identify the reasons for noncompliance in connection with its National Research Program (NRP). When asked to identify the reasons for changes proposed on returns audited in connection with the NRP, IRS auditors listed 67 percent as inadvertent mistakes, 27 percent as computational errors or errors that flowed automatically, and only 3 percent of the errors as intentional.\(^7\) Although the IRS does not regard these data as reliable, they are the only data available to date that attempt to measure the reasons for noncompliance.\(^8\) Even under the best of circumstances, it is difficult for auditors to determine a taxpayer's intent.\(^9\) However, this data does not support the popular perception that most noncompliance is intentional. To the contrary, it suggests that a high percentage of noncompliance may be inadvertent.

B. Taxpayers Frequently Fail to Claim Tax Benefits, Suggesting a Significant Amount of Noncompliance May Be Unintentional.

A wide variety of data suggest that taxpayers often fail to claim tax benefits for which they are eligible. Because it is unlikely that taxpayers would intentionally overpay, these data also suggest that a high percentage of noncompliance may be inadvertent. In 2006, for example, individual taxpayers were permitted to claim a one-time tax credit for telephone excise taxes that the government had improperly collected.\(^10\) The standard amount of the credit ranged from $30 to $60, depending on the number of exemptions the taxpayer was entitled to claim on the return.\(^11\) 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

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\(^7\) A Closer Look at the Size and Sources of the Tax Gap, Hearing Before the Subcomm. on Taxation and IRS Oversight, S. Finance Comm., 109th Cong. 5 (July 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate).

\(^8\) GAO, GAO-06-208T, Multiple Strategies, Better Compliance Data, and Long-Term Goals Are Needed to Improve Taxpayer Compliance 12-13 (Oct. 26, 2005).

\(^9\) IRS, Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance 6 (Aug. 2, 2007) (stating “the IRS does not have sufficient data to distinguish clearly the amount of noncompliance that arises from willful, as opposed to unintentional, mistakes. Moreover, the line between intentional and unintentional mistakes is often a grey one”). TAS is working with the IRS to determine if it is feasible for an auditor to determine the reasons for a taxpayer’s noncompliance.

\(^10\) See IRS Notice 2006-50, 2006-1 C.B. 1141. Unlike the other examples cited in this discussion, the telephone excise tax refunds were authorized by the Department of the Treasury after several circuits of the U.S. Court of Appeals ruled that the long-distance telephone services at issue were not subject to taxation.

taxpayers (37 million out of 133 million) did not claim the credit. Why would 37 million taxpayers fail to claim an authorized credit? The most likely explanation is that they never learned about it because they were already so overwhelmed by the complexity of their tax returns. In other words, this “misreporting” was inadvertent.

A separate study by the Government Accountability Office (GAO) analyzed the misreporting of capital gains transactions. The study concluded that 33 percent of taxpayers who misreported their income from securities transactions reported more capital gains than they actually realized. Where misreporting is inadvertent, from a statistical standpoint, one would expect that 50 percent of errors would be on the high side and 50 percent of errors would be on the low side. Thus, GAO’s finding that 33 percent of all taxpayer errors tended to cause overpayments of tax (and thus were clearly inadvertent) implies that an equal percentage of inadvertent errors caused taxpayers to underpay their tax – or, put differently, that 66 percent of all errors in capital gains misreporting were inadvertent.

C. Taxpayers Who Rely on Preparers Could Inadvertently Fail to Comply Because of Mistakes by the Preparers.

Taxpayers who rely on preparers could inadvertently fail to comply because of mistakes by the preparers. About 60 percent of all individual income tax filers used paid tax return preparers in 2009. Studies attempting to pinpoint the precise impact of preparers on compliance are contradictory and inconclusive. However, a wide

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13 One might assume that tax preparers would know about the credit. Yet IRS data show that 16 percent of practitioner-prepared returns failed to claim the credit. IRS Office of Research, Analysis, and Statistics, Response to TAS Information Request (Dec. 17, 2008). An alternative explanation we have heard is that some taxpayers were concerned that claiming the credit might increase their audit risk.


15 This analysis assumes inadvertent misreporting errors would be “normally” (or equally) distributed above and below the correct figure.

16 For a discussion of the role of preparers and their potential impact on tax compliance, see National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 44 (Leslie Book, Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws). A study conducted for the IRS found 98 percent of the respondents (taxpayers who were offered electronic filing but declined) said they trusted their preparer completely or very much. Russell Marketing Research, Pub. 4350, Findings from One-On-One e-file Research Among Taxpayers and Preparers 24 (June 2004).

17 IRS, CDW Tax Year 2009 (June 16, 2011).

18 Some research suggests preparers enhance compliance with unambiguous rules, but reduce it with respect to ambiguous ones. See Steven Klepper, Mark Mazur, and Daniel Nagin, Expert Intermediaries and Legal Compliance: The Case of Tax Preparers, 34 J. L. and Econ. 205 (1991). See also Kim M. B. Bloomquist, Michael F. Albert, and Ronald L. Edgerton, Evaluating Preparation
variety of data suggests they make frequent errors. For example, in 2006, GAO auditors posing as taxpayers made 19 visits to several national tax preparation chains in a large metropolitan area. Using two carefully designed fact patterns, they sought assistance in preparing tax returns. The tax preparation chains made errors on all 19 returns and significant errors on 17 of them. In another study, GAO found that about two million taxpayers overpaid by failing to itemize, even though about half used a preparer. Similarly, the Treasury Inspector General for Tax Administration identified about 230,000 returns filed by paid preparers where the taxpayer appeared eligible for Additional Child Tax Credits they did not claim. While these studies do not allow us to draw statistically valid conclusions about the amount of noncompliance resulting from preparers, they suggest that inadvertent noncompliance resulting from preparer errors could be significant. Moreover, the examples described above suggest that when the tax rules are complicated, a significant amount, perhaps even a majority of noncompliance, is inadvertent and thus could be reduced by simplifying the rules and making compliance easier.

III. The Causes of Noncompliance Vary, but Simplifying the Tax Code Could Address Many of Them.

As illustrated above, tax noncompliance is not just the result of intentional tax evasion. Accordingly, increased enforcement and penalties are not going to eliminate the tax gap. Generally, noncompliance is best described as a continuum of

Accuracy of Tax Practitioners: A Bootstrap Approach, Proceedings of the 2007 IRS Research Conference 77 (2007) (finding preparers reduce math errors, but increase the incidence of potential misreporting). Other research suggests preparers make frequent errors in a wide variety of areas. See, e.g., GAO, GAO-02-509, Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing (2002) (finding in 1998 about two million taxpayers overpaid by failing to itemize even though about half used a preparer); Treasury Inspector General for Tax Administration (TIGTA), Ref. No. 2003-40-046, Analysis of Statistical Information for Returns with Potentially Unclaimed Additional Child Tax Credit (Jan. 31, 2003) (finding about 230,000 returns filed by paid preparers in 2002 where taxpayers appeared eligible for Additional Child Tax Credits they did not claim); Janet Holtzblatt and Janet McCubbin, Issues Affecting Low-Income Filers, in The Crisis in Tax Administration 148, 159 (Henry J. Aaron and Joel Slemrod eds., 2004) (observing that about two-thirds of EITC returns, which have high levels of noncompliance, were prepared by paid preparers); GAO, GAO-06-563T, Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors 5, 23 (Apr. 4, 2006) (finding preparers made significant mistakes on 17 of the 19 returns prepared for GAO employees posing as taxpayers, including the omission of income on ten); TIGTA, Ref. No. 2008-40-171, Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors 2 (Sept. 3, 2008) (finding preparers made mistakes on 17 of the 28 returns prepared for TIGTA employees posing as taxpayers, including six willful or reckless errors).


behavior from inadvertent error to negligence to recklessness (in disregard of the law) to fraud at civil or criminal levels. Social scientists have identified at least eight types of noncompliance, including:

- **Procedural** – Failed to follow complicated procedural rules, such as quarterly filing requirements;
- **Lazy** – Failed to follow burdensome procedural rules, such as recordkeeping requirements;
- **Unknowing** – Misunderstood the legal rules;
- **Asocial** – Motivated by economic gain;
- **Brokered** – Acted on the advice of a professional;
- **Symbolic** – Perceived the law or the IRS as unfair;
- **Social** – Acted in accordance with social norms and peer behavior; and
- **Habitual** – Knowingly repeated previous noncompliance.22

Compliance may be influenced by the expected likelihood and cost of getting caught cheating (called “economic deterrence”), compliance norms (i.e., whether a taxpayer believes his or her peers comply), tax morale, trust in the government and the tax administration process, complexity and the convenience of complying, and the influence of tax preparers.23

Broadly speaking, we can also sort taxpayers into at least three categories based on their motivation to comply: (1) those who will go to great lengths to comply with whatever requirements exist; (2) those who view taxes as one of many burdens they face in everyday life and who will try to comply if doing so is easy and straightforward, particularly if they believe the government is fair and that other taxpayers generally comply; and (3) those who seek to avoid their tax obligations. Adopting tax administration strategies that are responsive to these motivational postures is consistent with the so-called “responsive regulation” compliance model, which has been endorsed by the Organization for Economic Co-operation and Development (OECD) Forum on Tax Administration Compliance Sub-group, and a number of tax agencies throughout the world.24 Reducing complexity, however, is a

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strategy that could improve compliance by taxpayers in each category, albeit for different reasons.

A. Complexity Leads to Inadvertent Errors, Even by Taxpayers Who Will Go to Great Lengths to Comply.

As described above, the indication by NRP auditors that many errors are inadvertent or computational, the data on capital gains overreporting, and the data regarding failure to claim the telephone excise tax credit demonstrate that considerable noncompliance is inadvertent. Accordingly, even taxpayers who will go to great lengths to comply may inadvertently fail if the rules are so complicated that they (or their preparers) cannot figure out what is required.

B. Complexity Creates Opportunities for Abuse that Can Be Exploited by Those Who Want to Avoid Their Tax Obligations.

Sophisticated taxpayers who want to avoid their taxes may exploit complicated loopholes. Many law firms, accounting firms, and investment banking firms have made tens of millions of dollars by scouring the tax code for ambiguities and then advising taxpayers to enter into transactions, with differing levels of business purpose or economic substance, to take advantage of those ambiguities. The IRS devotes significant resources to identifying these transactions and challenging them where appropriate. Many are legitimate under existing law, many more fall into a grey area, and some are illegitimate (i.e., asocial and brokered noncompliance from the typology above). For example, the infamous Son-of-BOSS (Bond and Option Sales Strategy) tax shelter arose from a misinterpretation of complicated rules governing how to compute tax basis when an entity assumes a contingent liability.25 In short, complexity encourages tax shelters and aggressive positions that reduce compliance, produce controversy, and waste both IRS and taxpayer resources, reducing respect for the tax system.

C. Complexity and the Resulting Loopholes, Inequities, and Burdens Alienate Those Who Are Trying to Comply.

Tax law complexity generates loopholes, unfair provisions, and burdensome requirements that foster noncompliance among taxpayers who fall into the second category – those who are trying to comply. I have previously recommended that any broad-based tax reform incorporate six core taxpayer-centric principles, which should help promote compliance by this group:

1. The tax system should not “entrap” taxpayers.

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

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

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

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

6. The tax code should incorporate a periodic review of itself – in short, a sanity check.26

The core concept here is that, to the greatest extent practicable, the tax rules should be simple and fair so that compliance is easy.27 Simple rules also make it easy for both taxpayers and the IRS to identify noncompliance. The following discussion elaborates upon why these concepts are so important.

1. Loopholes May Provide a Reason Not to Comply.

Complexity can be used to justify noncompliance by taxpayers who would otherwise try to comply. As noted above, complexity promotes tax loopholes and shelters. No one wants to feel like a “tax chump” – paying more than others who are taking advantage of loopholes or shelters to pay less. Taxpayers who believe they are unfairly paying more than others may feel justified in “fudging” to right this perceived wrong (i.e., symbolic noncompliance in the typology described above).28 Transparency is a critical feature of a successful tax system and is essential if the system is to build taxpayer confidence and maintain high rates of tax compliance. Simplifying the tax code so tax computations are more transparent would go a long way toward reassuring taxpayers that the system is not rigged against them.

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

27 While simplicity and fairness should be overriding objectives, we recognize that it is not always feasible to achieve both, and that at times, fairness may even require some degree of complexity.

28 Researchers attribute this to social “norms,” “reciprocity,” or tax “morale,” as discussed above.
2. Inequitable Provisions May Provide a Reason Not to Comply.

For the same reasons, it is also important to eliminate “tax traps” – anomalous tax rules that seem unfair, such as those that tax "phantom income" (i.e., income that the taxpayer did not really receive, or received and then lost, from an economic perspective). The so-called “ISO-AMT problem” illustrates how the tax rules sometimes produce “tax traps” that tax “phantom income.”

Example: ISO-AMT Problem – A Tax on Phantom Income. The Internal Revenue Code encourages companies to issue Incentive Stock Options (ISOs) to employees, which generally allow the employees to defer taxes. An employee is not subject to the regular income tax when an ISO is received or exercised. When an employee exercises an ISO, however, the employee may be subject to the Alternative Minimum Tax (AMT). The complexity of the AMT, combined with sudden stock market declines, meant that some employees who exercised ISOs but did not immediately sell the ISO-stock were effectively subject to a tax on “phantom income” that they did not receive and could not use to pay the tax. Given the unfairness of this result, we recommended that Congress take steps to address the problem legislatively and also direct the IRS to compromise tax liabilities resulting from phantom income. Congress ultimately passed two “fixes” intended to address the problem by accelerating AMT credits and abating certain AMT-related liabilities.

Such unfair results could move taxpayers in category two (those trying to comply) into category three (those looking for ways to avoid their tax obligations). Indeed, taxpayers began raising frivolous arguments to avoid this unfair tax so often that the IRS added several of them to its list of frivolous positions for which it would seek the penalty for frivolous tax submissions under IRC § 6702.

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29 See IRC § 421; IRC § 422.
30 IRC § 56(b)(3); IRC § 422(c)(2).
31 See, e.g., National Taxpayer Advocate 2004 Annual Report to Congress 433, 434 (Key Legislative Recommendation: Offer In Compromise: Effective Tax Administration); National Taxpayer Advocate 2004 Annual Report to Congress 383-85; National Taxpayer Advocate 2001 Annual Report to Congress 82-100; National Taxpayer Advocate FY 2009 Objectives Report to Congress xxxiii-xxxix.
3. Burden May Provide a Reason Not to Comply.

Other taxpayers in category two, who would otherwise try to comply if it were easier, may use complexity or burden as a reason to justify noncompliance.\textsuperscript{34} Similarly, when tax laws are burdensome, complicated, or ambiguous, these taxpayers may simply resolve uncertainty in their favor (\textit{i.e.}, procedural or lazy noncompliance).\textsuperscript{35} Some may not even know they are cheating because they do not understand the law or have difficulty with procedural requirements (\textit{i.e.}, unknowing noncompliance).

Tax gap data support the conclusion that tax compliance is highest when IRS procedures make it simple and easy. For example, withholding and third-party information reporting, which make it procedurally simpler and easier to report income and pay taxes, are key drivers of tax compliance.\textsuperscript{36} Reporting compliance rates are about 99 percent on wages subject to withholding and third-party information reporting, about 96 percent on income subject to full third-party information reporting (\textit{e.g.}, interest and dividends) – yet less than 50 percent on income not subject to third-party information reporting.\textsuperscript{37}

When a taxpayer receives a copy of an information reporting document showing income that has already been reported by a third party to the IRS, the taxpayer knows the IRS will notice if the income does not show up his or her return. Thus, “deterrence” likely accounts for some of these results.

Perhaps just as importantly, however, information reporting and withholding reduce two types of burdensome procedural complexity – the complexity of determining what income should be reflected on the return and the complexity of making (or funding)

\textsuperscript{34} See, \textit{e.g.}, \textit{Taxpayer Compliance, Volume 1: An Agenda for Research} 118, 128-129 (Jeffrey A. Rother, John T. Scholtz, and Ann Dryden Witte eds., Univ. of Penn. Press 1989) (discussing various studies suggesting that compliance burdens and complexity have an impact on tax compliance).

\textsuperscript{35} \textit{Id.}

\textsuperscript{36} For additional discussion of the importance of third party information reporting in prior testimony, see, \textit{e.g.}, \textit{The Tax Gap and Tax Shelters, Hearing Before the Senate Comm. on Finance} (July 21, 2004) (statement of Nina E. Olson, National Taxpayer Advocate); \textit{The Causes of and Solutions to the Federal Tax Gap, Hearing Before the Senate Comm. on the Budget} (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); \textit{The Tax Gap, Hearing Before the Senate Subcomm. on Federal Financial Management, Government Information, and International Security Comm. on Homeland Security and Governmental Affairs} (Sept. 26, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); \textit{The Causes of and Solutions to the Federal Tax Gap, Hearing Before the Senate Comm. on the Budget} (Feb. 15, 2006) (statement of Nina E. Olson, National Taxpayer Advocate); \textit{The IRS and the Tax Gap, Hearing Before the H. Comm. on the Budget} (Feb. 16, 2007) (statement of Nina E. Olson, National Taxpayer Advocate).

\textsuperscript{37} See IRS, \textit{Tax Gap Map for Year 2001} (Feb. 2007).
payments to the IRS. In this way, information reporting and withholding can reduce the tax gap by reducing burden and complexity.  


A. The Tax Code Imposes Excessive Compliance Burdens.

Consider the following:

- According to a TAS analysis of IRS data, individuals and businesses spend about 6.1 billion hours a year complying with the filing requirements of the Internal Revenue Code.  

- If tax compliance were an industry, it would be one of the largest in the United States. To consume 6.1 billion hours, the “tax industry” requires the equivalent of more than three million full-time workers.  

- 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

38 For a list of proposals to expand information reporting and withholding, many of which have been enacted in recent years, see National Taxpayer Advocate 2010 Annual Report to Congress 347, 357-359 (legislative proposals to reduce the tax gap).

39 The TAS Research function arrived at this estimate by multiplying the number of copies of each form filed for tax year 2008 by the average amount of time the IRS estimated it took to complete the form. While the IRS estimates are the most authoritative available, the amount of time the average taxpayer spends completing a form is difficult to measure with precision. This TAS estimate may be low because it does not take into account all forms and 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. We note that the aggregate burden of 6.1 billion hours is lower than the 7.6 billion hour estimate included in our 2008 Annual Report to Congress. Analysts in the IRS Office of Research, Analysis and Statistics (RAS) have advised us that the lower burden estimates likely reflect efficiency gains attributable to wider use of tax software, particularly by higher income business taxpayers. However, these efficiency gains have not necessarily reduced the burden on middle income and lower income taxpayers. Indeed, measured by dollars, RAS estimates that the mean burden has declined but the median burden has increased. TAS cannot independently determine the margin of error of existing estimates, and RAS acknowledges that the reduction in the time burden estimates may be at least partially attributable to measurement error.

40 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).
the individual and corporate income tax requirements for 2008 amounted to $163 billion – or a staggering 11 percent of aggregate income tax receipts.41

- According to a tally compiled by a leading publisher of tax information, there have been approximately 4,428 changes to the tax code over the past 10 years, an average of more than one a day, including an estimated 579 changes in 2010 alone.42

- Individual taxpayers find return preparation so overwhelming that about 60 percent now pay preparers to do it for them.43 Among unincorporated business taxpayers, the figure rises to about 71 percent.44 An additional 29 percent of individual taxpayers use tax software to help them prepare their returns,45 with leading software packages costing $50 or more. IRS researchers estimate the monetary compliance burden of the median

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41 The IRS and several outside analysts have attempted to quantify the costs of compliance. For an overview of previous studies, see GAO, GAO-05-878, Tax Policy: Summary of Estimates of the Costs of the Federal Tax System (Aug. 2005). There is no clearly correct methodology, and the results of these studies vary. All monetize the amount of time that taxpayers and their preparers spend complying with the tax code. The TAS estimate of the cost of complying with personal and business income tax requirements (and thus excluding the time spent complying with employment, estate and gift, excise, and exempt organization tax requirements) was made by multiplying the total number of such hours (5.6 billion) by the average hourly cost of a civilian employee ($29.18), as reported by the Bureau of Labor Statistics. See Bureau of Labor Statistics, U.S. Department of Labor, Employer Costs for Employee Compensation – December 2008, USDL: 09-0247 (Mar. 12, 2009) (including wages and benefits), http://www.bls.gov/news.release/archives/ecec_03122009.pdf. The TAS estimate of compliance costs as a percentage of total income tax receipts for 2008 was made by dividing the income tax compliance cost as computed above ($163 billion) by total 2008 income tax receipts ($1.45 trillion). See Office of Management and Budget, Budget of the United States Government - Fiscal Year 2011, Historical Tables, Table 2-1, http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/hist.pdf. TAS’s estimate that compliance costs amount to about 11 percent of aggregate income tax receipts falls on the lower side of some previous estimates. For example, Professor Joel Slemrod computed that compliance costs constitute about 13 percent of receipts, while the Tax Foundation computed that compliance costs constitute about 22 percent of income tax receipts. See Public Meeting of the President’s Advisory Panel on Federal Tax Reform (Mar. 3, 2005) (statement of Joel Slemrod, Paul W. McCracken Collegiate Professor of Business Economics and Public Policy, University of Michigan Stephen M. Ross School of Business); Scott Moody, Wendy P. Warcholik and Scott A. Hodge, Special Report: The Rising Cost of Complying with the Federal Income Tax (Tax Foundation, Dec. 2005), http://www.taxfoundation.org/research/show/1281.html.

42 Unpublished CCH data provided to TAS (Dec. 22, 2010).


44 IRS Compliance Data Warehouse, Individual Returns Transaction File (Tax Year 2008).

individual taxpayer (as measured by income) rose from $220 in 2000 to $258 in 2007, an increase of 17 percent.\textsuperscript{46}

B. Special Tax Benefits Add Complexity and Burden, May Seem Unfair, and May Provide a Reason Not to Comply.

The tax code contains a multitude of tax benefits that apply to narrow groups of taxpayers or industries. These special tax benefits are enacted for understandable reasons, including to encourage certain types of behavior or to provide benefits in certain circumstances. However, many do not need to be a part of the tax code because the same benefits could be delivered by making direct payments (\textit{i.e.}, they are “tax expenditures”). While any list is necessarily selective, here is a small sampling of narrow benefits, either intended or incidental, for which the average taxpayer does not qualify:

- \textit{Easement for Harmonious Shapes and Textures}. This provision allows donors of certain easements for conservation purposes to claim a charitable deduction, but it is almost impossible for the IRS to administer.\textsuperscript{47} For example, it requires valuation of real property rights that preserve historic facades of houses or preclude development of open space, which under the tax regulations take into account such variables as the “harmonious variety of shapes and textures” on a landscape.\textsuperscript{48}

- \textit{Electric Vehicle/Golf Cart Credit}. This provision provides a credit for the purchase of qualified plug-in electric vehicles, which at one point included golf carts.\textsuperscript{49} While that loophole has been closed, the credit still covers the $100,000-plus Tesla sports car.\textsuperscript{50}

- \textit{Film and TV Deduction}. This provision allows taxpayers to expense costs associated with the production of films and television programs in lieu of the less generous depreciation deduction generally available to businesses.\textsuperscript{51}

- \textit{Forestry Conservation Bonds}. This provision authorizes a credit for investors in bonds issued by a government or nonprofit entity for the purpose of

\textsuperscript{46} Id. at 26.
\textsuperscript{47} See IRC § 170(h).
\textsuperscript{49} See IRC § 30D.
\textsuperscript{51} See IRC § 181.
acquiring at least 40,000 acres adjacent to a national park, subject to a native fish habitat conservation plan of the U.S. Fish and Wildlife Service.52

• **Railroad Track Maintenance Credit:** This provision provides a special credit for taxpayers who happen to own a railroad.53

Many taxpayers who do not qualify for these special tax benefits will have a tax form, tax preparer, or tax software program ask them questions such as: “Are any of your expenses associated with the production of qualified films or television programs?” and “Do you own any Forestry Conservation Bonds?”54 Such questions burden taxpayers and cause them to waste time asking, “What is that?” Not only do such questions potentially reduce respect for the tax system and the government, and frustrate the goal of simplifying tax forms and the tax filing process for everyone, but they also convey the impression that some special group is paying less in taxes.

If these special tax benefits encourage even a small percentage of the vast majority of taxpayers who do not qualify for them to “claim” their own special tax benefit by “fudging” a bit to even the score, it could be costing the government a lot more than it believes it is spending on that tax expenditure by increasing noncompliance and the tax gap. In other words, the government may be losing more in revenue than a comparable direct expenditure would cost. Similarly, some taxpayers who would otherwise try to comply, but are overwhelmed by complex provisions, may fudge somewhere else on their return to achieve what they regard as a kind of rough justice.


Over the past decade, the National Taxpayer Advocate’s Annual Reports to Congress have included numerous proposals to simplify various sections or areas of the tax code. While these proposals were not written with the goal of comprehensive structural tax reform in mind, they should be considered as part of an overall tax reform process, and because they would simplify the tax code, they would probably reduce the tax gap. The following summary of key proposals highlights areas of unnecessary complexity that entangle a significant number of taxpayers.

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52 See IRC §§ 54A and 54B.

53 See IRC § 45G.

54 For example, IRS Form 8912 is devoted to various types of “credit bonds,” including qualified forestry conservation bonds. Similar guidance is devoted to qualified film and television production costs. See IRS Pub. 535, *Business Expenses* 26 (2010); Temp. Treas. Reg. §§ 1.181-1T through 1.181-6T.
1. Education Savings Tax Incentives Are Complicated.

The tax code contains at least 11 separate incentives to encourage taxpayers to save for and spend on education. The eligibility requirements, definitions of common terms, income-level thresholds, phase-out ranges, and inflation adjustments vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior. However, taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are aware of each of the education tax incentives and familiar enough with the particulars to make wise choices. Moreover, some who try to make informed choices will be overwhelmed by this complexity.

Recommendation: We have recommended that Congress consolidate incentives and harmonize definitions and other terms to the extent possible.55

2. Retirement Savings Tax Incentives Are Complicated.

The tax code contains at least 12 separate incentives to encourage taxpayers to save for retirement. These incentives are subject to different sets of rules governing eligibility, contribution limits, taxation of contributions and distributions, withdrawals, availability of loans, and portability. Similar to education incentives, the large number of options and lack of common definitions and terms can preclude taxpayers from making wise choices or understanding how each incentive works.

Example: Retirement Plans with Different “Hardship Withdrawal” Provisions. While some retirement plans allow for an early distribution upon the event of a hardship, the various plans do not uniformly apply these so-called “hardship withdrawal” provisions. So-called 401(k) plans are permitted to allow participants to take an early distribution of their elective deferrals “upon hardship of the employee,”56 but such distributions are still subject to the ten-percent additional tax on early distributions.57 Section 457(b) plans (which cover state and local government employees) are permitted to allow participants to take an early distribution of their entire benefit for an “unforeseeable emergency,”58 and those distributions, are exempt from the ten-percent additional tax. Traditional individual retirement accounts (IRAs) do not allow hardship withdrawals per se, but consider first-time home purchases and certain education expenses, among others, to be “qualified distributions,”

55 See National Taxpayer Advocate 2008 Annual Report to Congress 370-372 (Legislative Recommendation: Simplify and Streamline Education Tax Incentives); National Taxpayer Advocate 2004 Annual Report to Congress 403-422 (Legislative Recommendation: Simplification of Provisions to Encourage Education).

56 IRC § 401(k)(2)(B)(i)(IV).

57 IRC § 72(t).

58 IRC § 457(d)(1)(A)(iii).
and therefore not subject to the ten-percent additional tax. A single taxpayer who has what would be deemed a hardship under one plan but not another could essentially be penalized by the tax code for making a withdrawal from the wrong plan. Absent compelling policy arguments, it is inefficient and unreasonable to require taxpayers to learn and apply a new set of rules for each retirement plan.

Recommendation: We have recommended that Congress consolidate existing retirement incentives, particularly where the differences in plan attributes are minor. For instance, Congress should consider establishing one retirement plan for individual taxpayers, one for plans offered by small businesses, and one suitable for large businesses and governmental entities (eliminating plans that are limited to governmental entities). At a minimum, Congress should establish uniform rules regarding hardship withdrawals, plan loans, and portability.

3. Late S Corporation Election Relief Procedures Are Complicated.

Corporations, especially small ones, often seek to qualify as “Subchapter S” corporations. In addition to possessing traditional corporate attributes such as limited liability and transferable ownership, S corporations are not subject to the corporate level income tax. Rather, they “pass through” profits or losses to their shareholders, who in turn report the corporation’s income and losses on their individual returns. Small business corporations may elect to be treated as pass-through entities by submitting Form 2553, Election by a Small Business Corporation, on or before the 15th day of the third month of the tax year, while an S corporation tax return is not due until the 15th day of the third month after the end of the tax year. Because of such procedural complexity, many newly created corporations that desire S status overlook this requirement, subjecting themselves to serious tax consequences that include taxation at the corporate level and the inability to deduct operating losses on shareholders’ individual tax returns.

Businesses that wait until the tax return filing date to make this election are deemed to have made the election for the succeeding year, and must seek retroactive relief upon a showing of reasonable cause under one of four revenue procedures or

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59 IRC § 72(t)(2).
60 See National Taxpayer Advocate 2008 Annual Report to Congress 373-374 (Legislative Recommendation: Simplify and Streamline Retirement Savings Tax Incentives); National Taxpayer Advocate 2004 Annual Report to Congress 423-432 (Legislative Recommendation: Simplification of Provisions to Encourage Retirement Savings).
61 IRC § 1361(a)(1) defines an “S corporation” as “a small business corporation for which an election under §1362(a) is in effect for such year.”
62 IRC § 1362(b)(1)(B); Treas. Reg. § 1.1362-6(a)(2).
63 IRC §§ 6037 and 6072(b); Treas. Reg. § 1.6037-1(b); Instructions for Form 1120S, U.S. Income Tax Return for an S Corporation, at 2 (2010).
through a private letter ruling (PLR) request. Challenges in the S election process for taxpayers include the complexity of relief procedures for a late S corporation election; the often prohibitive cost of retroactive relief via a PLR; the IRS’s inability to verify the receipt and acceptance of S corporation returns and election applications; and the downstream burdens on shareholders of the conversion of S corporation returns to regular, taxable corporate returns. In processing years 2008 and 2009, 81,431 and 97,823 S corporation returns, respectively, could not be processed as filed because of missing or late elections, IRS errors in recognizing or processing a valid election, and an absence of effective relief procedures. These unprocessed returns accounted for nearly 17 percent and 24 percent of all new S corporation filings for those two years.

Recommendation: To alleviate the burden on small businesses, we recommended that Congress simplify the S corporation election process to allow a small business corporation to elect to be treated as an S corporation by checking a box on its timely filed (including extensions) Form 1120S, U.S. Income Tax Return for an S Corporation. We also recommended that the IRS expedite the issuance of a consolidated revenue procedure for late election relief; immediately identify and correct accounts where tax was assessed without following deficiency procedures; expand outreach efforts to include a simple and complete guide to the late election relief process; develop an administrative appeal process for taxpayers whose elections are denied; and allow electronic filing of the S corporation election form.


65 Business Master File (BMF) Extract from IRS Compliance Data Warehouse (CDW) for Processing Years 2007-2009 (June 2010). If there is no election on file, the return information cannot “post” to the IRS Master File, and the return becomes “unpostable.”

66 Prior IRS research reports revealed approximately 20 percent of these returns remain unpostable for multiple years. IRS, Small Business/Self-Employed Division (SB/SE) Research report, Profile Taxpayers with Unpostable Initial 1120S Returns (May 2007).

67 See National Taxpayer Advocate 2010 Annual Report to Congress 410-411 (Legislative Recommendation: Extend the Due Date for S Corporation Elections to Reduce the High Rate of Untimely Elections). See also National Taxpayer Advocate 2004 Annual Report to Congress 390; National Taxpayer Advocate 2002 Annual Report to Congress 246. Under our recommendation, the requirement that all shareholders must consent to the S election would remain in place.

4. Determining Whether to Classify Workers as Employees or Independent Contractors Is Complicated.

Misclassification of workers can have serious consequences for workers and the recipients of the services they provide. Whether a worker is classified as an employee or independent contractor affects the application of labor laws as well as tax treatment for both the worker and the service recipient. Unfortunately, the rules are complex and ambiguous, leading to intentional as well as inadvertent noncompliance. Taxpayers must navigate a complicated and subjective 20-factor test to determine the proper classification. A “safe harbor,” enacted as Section § 530 of the Revenue Act of 1978, adds to the confusion, “deeming” a worker to be an independent contractor for employment tax purposes but not income tax purposes under certain circumstances. To make matters worse, because the Revenue Act of 1978 prohibits Treasury and the IRS from publishing regulations and revenue rulings on worker classification for employment taxes, there is no current guidance.

Recommendation: We have recommended that Congress: (1) Replace § 530 with a provision applicable to both employment and income taxes, and require the IRS to consult with affected industries and report back to the tax-writing committees on the findings of such consultations, with the ultimate goal on the part of the Secretary to issue guidance based on such findings, including a 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

69 Such protections include the Fair Labor Standards Act, Family Medical Leave Act, Occupational Safety and Health Act, and the National Labor Relations Act. Misclassified workers may also lose access to employer-provided benefits such as health insurance coverage and pensions. See GAO, GAO-07-859T, Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification (May 8, 2007); Subcomm. on Income Security and Family Support, Comm. On Ways and Means, Advisory ISFS-6 (May 1, 2007).

70 For a detailed discussion of the tax treatment of both classifications, see Joint Committee on Taxation, Present Law and Background Relating to Worker Classification for Federal Tax Purposes Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures and the Subcommittee on Income Security and Family Support of the House Committee on Ways and Means on May 8, 2007, JCX-26-07 (May 7, 2007).

71 In Revenue Ruling 87-41, 1987-1 C.B. 296, the IRS developed a list of 20 factors, based on cases and rulings decided over the years, to determine whether an employer-employee relationship exists.


73 Our initial recommendation required the Secretary to issue guidance. However, based on our discussions with small business groups, we subsequently refined the recommendation to propose that Congress mandate the IRS to hold a series of consultations with the industry and report back to the tax writing committee on findings. See National Taxpayer Advocate 2008 Annual Report to Congress 375-390.

74 IRC § 7436 allows an employer that has been audited regarding employment taxes to petition the United States Tax Court to litigate the issue of whether a worker is an independent contractor or employee, or whether the employer is entitled to relief from any misclassification under § 530 of the
outreach and education campaigns to increase awareness of the rules as well as the consequences associated with worker classification.\textsuperscript{75}

5. The Alternative Minimum Tax for Individuals Is Complicated.

The AMT effectively requires taxpayers to compute their taxes twice – once under the regular tax rules and again under the AMT rules – and then to pay the higher of the two amounts. The regular rules allow taxpayers to claim tax deductions for each dependent (recognizing the costs of maintaining a household and raising a family) and for taxes paid to state and local governments (reducing “double taxation” at the federal and state levels), but the AMT rules disallow those deductions. An estimated 77 percent of all additional income subject to tax under the AMT is attributable to the disallowance of deductions for dependents and state and local tax payments. The AMT computations are also extremely burdensome, and even taxpayers who are not ultimately subject to the AMT are burdened because they have to fill out a series of forms and worksheets just to find out whether the AMT applies.

\textit{Recommendation:} We have recommended that the AMT be repealed.\textsuperscript{76}


Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004,\textsuperscript{77} the family status provisions continue to ensnare

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Revenue Act of 1978. The collection of any underpayment of employment taxes is barred while the action is pending. This provision does not authorize the employee to petition the Tax Court or intervene in a pending Tax Court case brought by the employer.

\textsuperscript{75} See National Taxpayer Advocate 2008 Annual Report to Congress 375-390 (Legislative Recommendation: \textit{Worker Classification}).

\textsuperscript{76} The National Taxpayer Advocate has repeatedly identified the AMT as a serious problem for taxpayers and has recommended its repeal in prior reports and congressional testimony since 2001. See National Taxpayer Advocate 2008 Annual Report to Congress 356-362 (Legislative Recommendation: \textit{Repeal the Alternative Minimum Tax for Individuals}); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: \textit{Alternative Minimum Tax for Individuals}); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: \textit{Alternative Minimum Tax}); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: \textit{Alternative Minimum Tax for Individuals}); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: \textit{Alternative Minimum Tax for Individuals}); see also \textit{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); \textit{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).

\textsuperscript{77} See Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004). This legislation was adopted following a recommendation by the National Taxpayer Advocate. See National Taxpayer Advocate 2001 Annual Report to Congress 78-100 (recommending Congress adopt a uniform definition of a “qualifying child”). See also Dept. of the Treasury, \textit{Proposal for Uniform Definition of a Qualifying Child} (Apr. 2002).
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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 (EITC), the child and dependent care credit, and the separated spouse rule under IRC § 7703(b). Many of the eligibility requirements – such as support or maintenance costs of the home – are difficult for the IRS to verify without conducting audits into taxpayers' personal and private lives.

**Recommendation:** We have recommended that, as part of a comprehensive reform of the 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.79

7. **Taxation of the Family Unit Is Complicated.**

The tax code currently imposes “joint and several liability” on married persons who file a joint federal income tax return. This concept dates back to the early years of the income tax when a husband was typically the sole wage earner for the family unit. Today, husbands and wives often have separate assets and incomes that they do not equally control. Recognizing that it is inequitable to hold one spouse liable for tax on the other spouse’s income, at least in cases where he or she does not know about the income of the other spouse and does not significantly benefit from it, Congress has enacted relief rules. However, these relief rules are complex, do not always produce the right result, and impose a large burden on the “innocent spouse” to prove his or her case.

**Recommendation:** We have recommended several steps to improve equity and simplify the rules, including eliminating joint and several liability for joint filers.82

The “kiddie tax” rules are another family-related area of taxation that create significant burden for some taxpayers. The tax code currently taxes a minor child’s unearned income above a certain threshold at the parent’s tax rate. The parent must

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78 See generally IRC §§ 1, 24, 151, 32, and 21.
80 IRC § 6013(d).
82 See National Taxpayer Advocate 2005 Annual Report to Congress 407-432 (Legislative Recommendation: *Another Marriage Penalty: Taxing the Wrong Spouse*); see also National Taxpayer Advocate 2001 Annual Report to Congress 128-165 (Legislative Recommendation: *Joint and Several Liability*).
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.

**Recommendation:** We have 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.83

8. **Tax Rules that Automatically Expire or “Sunset” Are Complicated.**

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. These sunset provisions make it difficult for both the government and taxpayers to plan ahead, especially when it is uncertain whether Congress will extend a provision that is set to expire. The complexity and uncertainty caused by sunsets make it more difficult for taxpayers to estimate liabilities and pay the correct amount of estimated taxes, complicate tax administration for the IRS, reduce the effectiveness of tax incentives, and may even reduce tax compliance.

**Recommendation:** We have recommended several ways for Congress to reduce or eliminate the procedural incentives to enact temporary tax provisions.84

9. **Tax Benefits that Change or “Phase-Out” as Income Increases Are Complicated.**

More than half of all individual income tax returns filed each year are affected by the phase-out of certain tax benefits as a taxpayer’s income increases.85 There are, in fact, legitimate policy reasons for using phase-outs in certain circumstances. Like tax sunsets, however, phase-outs are largely used to reduce the cost of tax provisions for budget-scoring purposes. Moreover, phase-outs are burdensome for taxpayers, reduce the effectiveness of tax incentives, and make it more difficult for taxpayers to

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83 See National Taxpayer Advocate 2002 Annual Report to Congress 231-242 (Legislative Recommendation: Children’s Income).

84 See National Taxpayer Advocate 2008 Annual Report to Congress 397-409 (Legislative Recommendation: Eliminate (or Reduce) Procedural Incentives for Lawmakers to Enact Tax Sunsets).

85 This data is compiled from the Individual Return Transaction File (IRTF) for Tax Year 2004 from the Compliance Data Warehouse (CDW).
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 tax code.

Recommendation: We have recommended that Congress repeal phase-outs or at least reassess them individually to ensure that they are necessary, given the complexity they add to the tax code.

V. Complexity Begets More Complexity, Burden, and Noncompliance, as It Creates Opportunities for Abuse, Which in Turn Spur More Complex Legislation that May Alienate Taxpayers.

Complexity in the tax law can arise in response to abuse. Ironically, anti-abuse measures may confuse, burden, and alienate taxpayers who had been trying to comply, potentially triggering unintended consequences and increasing the tax gap. Consider the following examples.

A. The Personal Injury Settlement Exclusion Is Complicated to Address Perceived Abuse.

Prior to 1996, a payment that made an injured person whole was not includible in gross income. As a result, the portion of a personal injury settlement allocable to punitive damages or awards for injury to reputation could go untaxed. In 1996, Congress addressed this perceived abuse by limiting the personal injury exclusion to apply only to compensation for physical injury or sickness. This is because the nontaxable portion of his social security benefits is phased out as his income increases, and the bonus also pushes him into the phase-out range for the Hope credit for educational expenses. As a result of these phase outs, the $500 bonus increased his income tax liability by about $357, meaning he would only get to keep the remaining $143 (or about 30 percent of the bonus). In contrast, if the $500 bonus were paid to someone in the highest 35 percent income tax bracket, he or she would typically get to keep $325 – more than twice as much. Moreover, if the taxpayer did not anticipate the effect of these phase-outs on his tax liability, he could be unexpectedly under-withheld.

For additional details, see National Taxpayer Advocate 2008 Annual Report to Congress 410-413.

86 For example, if a 63-year-old retiree with $15,000 in social security benefits, $15,000 in wage income, $20,000 in taxable pension income, and two children in college received a $500 bonus in 2007, he would have been subject to a marginal income tax rate of about 70 percent on the bonus. This is because the nontaxable portion of his social security benefits is phased out as his income increases, and the bonus also pushes him into the phase-out range for the Hope credit for educational expenses. As a result of these phase outs, the $500 bonus increased his income tax liability by about $357, meaning he would only get to keep the remaining $143 (or about 30 percent of the bonus). In contrast, if the $500 bonus were paid to someone in the highest 35 percent income tax bracket, he or she would typically get to keep $325 – more than twice as much. Moreover, if the taxpayer did not anticipate the effect of these phase-outs on his tax liability, he could be unexpectedly under-withheld.

For additional details, see National Taxpayer Advocate 2008 Annual Report to Congress 410-413.

87 See National Taxpayer Advocate 2008 Annual Report to Congress 410-413 (Legislative Recommendation: Eliminate (or Simplify) Phase-outs).


change created a distinction between physical and non-physical injuries – a distinction that many view as increasingly unjustified given scientific advances showing that mental suffering can lead to physical symptoms and that physical injury can lead to mental suffering. It also increased tax law complexity and inequity, burdening and alienating injured taxpayers. Injured taxpayers who are well-represented can minimize the tax consequences of settlements by structuring their settlement agreement to allocate an agreed amount of the proceeds to physical injuries, but others who are not aware of this complicated approach may receive less beneficial tax treatment.

In addition, because non-physical personal injury settlements are not excludable, they may generate “phantom” income. Taxpayers are subject to tax on all non-physical settlement proceeds, even the portion taken off the top to pay contingent attorney fees. Although attorney fees might otherwise be deductible, limitations on miscellaneous itemized deductions – namely, a floor of two percent of adjusted gross income, a ceiling for high-income taxpayers, and total disallowance if the AMT applies – effectively eliminate the deduction for many injured persons. Tragically, the inclusion of settlement proceeds coupled with the lack of a deduction for attorney fees can leave an injured person worse off than before – owing more in tax than he or she received after paying attorney fees.

Recommendation: To reduce complexity and inequity, we recommended legislation to exclude from gross income payments received in settlement for mental anguish, emotional distress, or pain and suffering. If this recommendation was not adopted, we recommended legislation to allow an above-the-line deduction for attorney fees paid in connection with the receipt of such payments.

B. The Home Office Deduction Is Complicated to Address Perceived Abuse.

Generally, taxpayers may deduct ordinary and necessary expenses of a trade or business but not personal, living, and family expenses. Before 1976, some courts...
held that employees could deduct the costs of maintaining an office in their homes if it were “appropriate and helpful” to the employee's business.\textsuperscript{96} In 1976, Congress revised the rules, explaining that under the “appropriate and helpful” standard:

> expenses otherwise considered nondeductible personal, living, and family expenses might be converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence.\textsuperscript{97}

Congress also concluded that the deductibility of the business use of a home causes “inherent administrative problems because both business and personal uses of the residence are involved and substantiation of the time used for each of these activities is clearly a subjective determination.”\textsuperscript{98} Accordingly, Congress limited the home office deduction in several complicated ways.

Currently, a home office deduction is allowed for a portion of a home regularly and exclusively used as a principal place of business for the taxpayer’s trade or business, or a place to meet patients, clients, or customers in the normal course of the taxpayer’s trade or business.\textsuperscript{99} Special rules and tests apply to structures separate from the home, to employees, to portions of the home used to store inventory or product samples, and to structures used to provide daycare services.\textsuperscript{100} The home office deduction is also disallowed to the extent it would generate or increase a net loss for the business.\textsuperscript{101} When the taxpayer sells his or her residence, any allowable depreciation is subject to tax, unless the taxpayer can establish that he or she actually deducted less than the amount allowed.\textsuperscript{102}

**Recommendation:** To reduce the complexity of the current requirements, we have recommended legislation to create an optional standard home office deduction.\textsuperscript{103} Taxpayers would calculate the deduction by multiplying an applicable standard rate, as determined and published by the IRS on a periodic basis, by the applicable

\begin{itemize}
\item \textsuperscript{96} H.R. Rep. No. 94-658, at 144-145 (1975) (citations omitted).
\item \textsuperscript{97} Id.
\item \textsuperscript{98} Id.
\item \textsuperscript{99} See IRC § 280A(c)(1).
\item \textsuperscript{100} See IRC § 280A(c)(1), (2), and (4).
\item \textsuperscript{101} See IRC § 280A(c)(5).
\item \textsuperscript{102} On an annual basis, the taxpayer must reduce the adjusted basis of the home by the amount of the allowable depreciation. IRC § 167(e)(3).
\item \textsuperscript{103} See National Taxpayer Advocate 2007 Annual Report to Congress 503 (Legislative Recommendation: *Home Office Business Deduction*). 
\end{itemize}
square footage of the portion of the home used as an office. Ideally, taxpayers would simply report the optional standard deduction on revised versions of Schedule A, Itemized Deductions; Schedule C, Profit or Loss From Business; and Schedule F, Profit or Loss From Farming.  

C. Burdensome Strict Liability Penalties and Certain Automated Assessment Procedures Were Adopted to Address Perceived Abuse.

Penalties, including strict liability penalties, may promote voluntary compliance. They can discourage taxpayers from interpreting complicated tax laws in unreasonable ways so as to avoid their tax obligations. In some situations, laws that allow taxpayers to avoid a penalty if they have "reasonable cause" for a violation may waste IRS resources, delay application of the penalty, and dilute the deterrent effect of the penalty. However, complicated tax laws also make it more likely that taxpayers who have acted reasonably in trying to comply will, nonetheless, fail and be subjected to penalties. Penalizing taxpayers who acted reasonably in trying to comply – which may occur with strict liability penalties – will alienate them, potentially reducing voluntary compliance, even though promoting voluntary compliance is supposed to be the goal of civil tax penalties. The following discussion highlights a few examples.

1. Strict Liability Penalties, Although Intended to Address Abuse, Alienate Taxpayers Who Acted Reasonably in Trying to Comply.

During the late 1990s, the Treasury Department observed an increase in corporate tax shelters. Congress attempted to reduce the economic benefit of such shelters.

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104 For the reporting requirements associated with this deduction, see IRS Pub. 587, Business Use of Your Home. The home office business deduction is reported on several different schedules, depending on whether the taxpayer is an employee (Schedule A), a self-employed individual with non-farm business income (Schedule C), or a self-employed individual with farm income (Schedule F). Employees who itemize deductions on Schedule A report the deduction on Line 21, “Unreimbursed employee expenses.” The taxpayer must also attach Form 2106, Employee Business Expenses.

105 The standard rate must include a clearly identifiable depreciation component for taxpayers to be able to track depreciation. Upon the sale of a residence, taxpayers must recapture any allowed or allowable additional depreciation pursuant to IRC § 1250. For simplification, the depreciation component should be calculated based on the straight-line method of depreciation to render the recapture calculation unnecessary. Nonetheless, the taxpayer would still need to track depreciation, because upon the sale of the residence, the amount of the home sale exclusion in IRC § 121 must be reduced by any depreciation allowed or allowable after May 6, 1997.

106 H.R. Conf. Rep. No. 101-386, at 661 (1989) (stating in connection with significant civil tax penalty reform, “[t]he IRS should develop a policy statement emphasizing that civil tax penalties exist for the purpose of encouraging voluntary compliance.”); Policy Statement P-1-18, IRM 1.2.1.2.3 (Apr. 27, 1992) (“Penalties support the Service’s mission only if penalties enhance voluntary compliance.”); Policy Statement 20-1, IRM 1.2.20.1.1 (June 29, 2004) (“Penalties are used to enhance voluntary compliance.”).

107 See, e.g., Department of Treasury, The Problem of Corporate Tax Shelters Discussion, Analysis and Legislative Proposals (July 1999).
in a variety of ways, such as by increasing civil tax penalties and eliminating “reasonable cause” exceptions. Some tax shelters seem so egregious and “too good to be true” that the taxpayer should be penalized regardless of the explanation. Informal discussions with practitioners suggest sheltering behavior has significantly declined in recent years. Nonetheless, more and more penalties apply even if the taxpayer had “reasonable cause” for a tax position (i.e., they are “strict liability” penalties).

Ironically, outside the shelter context, a taxpayer conducting a mechanical cost-benefit analysis might conclude that the strict liability penalty reduces the marginal benefit of trying to comply – why bother spending the resources to try to comply if compliance is difficult and the government will penalize failure in any event? In fact, perhaps because of a concern that clever tax practitioners would help taxpayers avoid the rules if they were clear, there is little guidance about what the government expects taxpayers to do to avoid many of these penalties. As a result, it is more

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109 For well-reasoned counter-arguments, see, e.g., N. Jerold Cohen, Too Good To Be True And Too Bad To Be True, 109 Tax Notes 1437 (Dec. 12, 2005) (“With well-publicized example after example of situations in which the code reaches results that are not only unexpected, but also too good or too bad to be true, it seems inappropriate to impose penalties on taxpayers who not only follow advice from tax professionals but also can see that the advice is based on the literal language of the code.”). Interestingly, in the absence of express legislative direction to the contrary, courts will generally require the government to prove a person had the requisite knowledge or “mens rea,” before he or she can be held criminally responsible for violating laws governing an item unless the mere possession of the item such as a grenade or narcotic alerts him he is dealing with a device of highly regulated and dangerous character. See, e.g., Staples v. U.S., 511 U.S. 600, (1994) (distinguishing criminal laws governing guns from those governing grenades and narcotics).

110 For example, the penalty applicable to transactions deemed to lack “economic substance,” the penalty for “substantial understatements” due to transactions with “a significant purpose of tax avoidance,” and the penalty for failure to make special disclosures with respect to a “listed transaction” or a transaction “substantially similar” to a listed transaction are all strict liability penalties that apply even if the taxpayer made reasonable and good faith efforts to comply with the rules. See, e.g., IRC § 6707A (no reasonable cause exception for failure to disclose a listed transaction); IRC § 6662(d)(2)(C) (no reasonable cause exception for transactions with a significant purpose of tax avoidance); IRC § 6662A (no reasonable cause exception for reportable transactions with a significant purpose of tax avoidance); IRC § 6664(d)(2) (no reasonable cause exception for transactions lacking economic substance).

111 Accord A. Mitchell Polinsky and Steven Shavell, The Economic Theory of Public Enforcement of Law, 38 J. Econ. Literature 45, 70 (2000) (“Mistaken conviction [also] lowers deterrence because it reduces the difference between the expected fine from violating the law and not violating it.”)

112 See, e.g., American Bar Association Section of Taxation, Request for Guidance on Implementation of Economic Substance Legislation (Jan. 18, 2011) (requesting guidance); New York Bar Association
likely that the vast majority of taxpayers, who are trying to comply with the rules rather than skirt them, will inadvertently violate them and be penalized.

Penalizing taxpayers who have reasonably tried to comply alienates them and undermines respect for the IRS and the tax system. If such penalties alienate even a small percentage of the vast majority of taxpayers who are trying to comply, they may actually increase the tax gap by reducing voluntary compliance.

**Example: Strict Liability Penalty Under Section 6707A.** Section 6707A of the tax code imposes a penalty of between $5,000 and $100,000 per individual per year and between $10,000 and $200,000 per entity per year for failure to make special disclosures of a “listed transaction.” Enacted in 2004 to help combat tax shelters, this penalty can have a devastating impact on taxpayers who were trying to comply. The penalty must be imposed if a taxpayer fails to make the special disclosures – even if the taxpayer had no knowledge that the transaction was listed or even questionable, even if the taxpayer derived no tax savings from the transaction, and even if the transaction is not “listed” until years after the taxpayer entered into it and filed a return on which the transaction was reflected.113 A taxpayer who does business through a wholly owned S corporation may be subject to a penalty of $300,000 ($200,000 at the entity level and $100,000 at the individual level) for each year in which the transaction is reflected on a return. The requirement that this penalty be imposed without regard to culpability may have the effect of bankrupting middle class families who had no intention of entering into a tax shelter.114

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113 Ignorance of the law is generally not a defense to criminal prosecution. However, because tax laws are complicated, Congress has provided that to be convicted of criminal tax evasion a violation generally must be “willful,” which is interpreted as a “voluntary, intentional violation of a known legal duty.” *Cheek v. U.S.*, 498 U.S. 192, 199-201 (1991). In this context, a sincerely held but unreasonable belief that wages are not income within the meaning of the Internal Revenue Code can negate willfulness required for conviction of criminal tax evasion. *Id.* at 206-208. By contrast, a sincerely held and reasonable belief does not excuse a civil violation for failure to file an information return in situations, such as this, where a strict liability penalty applies.

114 The Section 6707A penalty was originally $100,000 for individuals and $200,000 for entities, regardless of the amount of the decrease in tax shown on the return. In the National Taxpayer Advocate’s 2008 Annual Report to Congress, we highlighted the unfair and extreme results this penalty could produce and recommended changes. See National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 24 (recommending legislation to make the penalty proportional to the decrease in tax, establish a “reasonable cause” exception, and to eliminate the potential for stacking); National Taxpayer Advocate 2008 Annual Report to Congress 419, 422 (same). Congress subsequently revised the penalty to be 75 percent of the decrease in tax resulting from the
Recommendation: To prevent the penalty for failure to report a listed transaction from alienating taxpayers who have reasonably tried to comply, we recommended legislation to establish a reasonable cause exception.\textsuperscript{115}

2. The Trust Fund Recovery Penalty, Although Intended to Address Abuse, May Harm Businesses Unnecessarily and Alienate Taxpayers Who Acted Reasonably in Trying to Comply.

The “trust fund recovery penalty” (TFRP) is another example of a penalty that can burden and alienate taxpayers who acted reasonably in trying to comply. Employers are generally required to withhold employment taxes and certain types of excise taxes, often called “trust fund” taxes, from payments to employees. IRC § 6672 provides for the assessment of a TFRP against defined “responsible persons” when these monies are not paid as required. To establish liability for this penalty, the IRS must conclude that the failure to pay the trust fund taxes was willful. Willfulness is established if the person had knowledge of the employer’s obligation to pay the taxes and knew the funds were being used for other purposes.

The TFRP statute does not contain a “reasonable cause” exception, nor does it treat the delinquency differently if it was caused by a third-party bad act such as mismanagement or embezzlement by an employee or third-party payor. Even after such embezzlement or mismanagement is discovered, the decision to pay current operating expenses (including payroll) rather than the delinquent trust fund taxes is considered willful.\textsuperscript{116} When funds are not available to cover both the payroll and the delinquent trust fund taxes, the responsible person has a duty to prorate the available funds between the United States and the employees, so that the taxes are fully paid on the amount of wages paid.\textsuperscript{117} Attempting to pay the delinquent taxes while at the same time paying current operating expenses may force financially struggling businesses to close. Moreover, from the taxpayer’s perspective, he or she has already paid the tax. Thus, in such situations the penalty may alienate taxpayers who acted reasonably in trying to comply.

Recommendation: We have recommended that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund


\textsuperscript{116} Hochstein v. United States, 900 F.2d 543 (2d Cir. 1990).

\textsuperscript{117} Id. See also IRM 5.17.7.1.3 (Aug. 1, 2010). The delinquent trust fund taxes can be paid via an installment agreement. IRM 5.7.7.1 (April 13, 2006).
taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS’s determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations.  

3. Automatically Assessing Accuracy-Related Penalties, Although Intended to Address Abuse, Alienates Taxpayers Who Have Acted Reasonably in Trying to Comply.

When the IRS detects an error on a tax return, it automatically assesses an accuracy-related penalty before communicating with the taxpayer to determine whether the taxpayer had a reasonable cause for the violation. Even if a penalty is ultimately abated, the time, effort, and resources the taxpayer must spend to respond to the assessment essentially penalizes the taxpayer in a manner similar to a strict liability penalty because the taxpayer cannot recover these costs.

Recommendation: We have recommended legislation to prevent the IRS from automatically assessing accuracy-related penalties without managerial review.

D. Efforts to Curb Improper Payment of Special Tax Benefits Introduce Burden and Procedural Complexity that Can Frustrate the Purpose of Providing the Benefits Through the Code.

As noted above, the tax code is filled with special benefits. Some tax benefits that are equivalent to expenditures are known as “tax expenditures.” They can take many forms, including deductions, refundable and nonrefundable credits, or preferential tax rates. Because many people already provide the IRS with detailed annual income information, it may seem sensible to have the IRS administer various income-based benefit programs. While some tax expenditures benefit wealthy taxpayers, others are

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118 See National Taxpayer Advocate 2010 Annual Report to Congress 400-405.


121 There are currently over 170 tax expenditures worth approximately $1.1 trillion. See Office of Management and Budget (OMB), Budget of the United States Government FY 2011, Analytical Perspectives, Ch. 16 (Tax Expenditures), Table 16-1 at 209-13. OMB does not report the total because its simple addition does not account for interaction effects among provisions. See Leonard Burman, Eric Toder and Christopher Geissler, How Big Are Total Individual Income Tax Expenditures, and Who Benefits from Them? Discussion Paper 31, 3, Amer. Soc. Sci. Assoc’n (New Orleans, La., Jan. 5, 2008), 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”); but see OMB, USG Budget FY 1985, Special Analysis G, Tax Expenditures G-16 (stating “tax expenditure estimates cannot simply be added together to obtain totals for functional areas or a grand total”).
designed as a substitute for social programs to deliver benefits, such as refundable tax credits, to middle and low income populations.122 Such populations may face socio-economic, educational, mobility, language, and literacy challenges.

When the IRS is tasked with both delivering special benefits and ensuring compliance with the eligibility rules, an excessive focus on its traditional revenue collection approach – which may assume that taxpayers fall into category three (discussed above) and are seeking to avoid taxes and claim benefits for which they are not eligible unless they can prove otherwise – is problematic. Such an approach is likely to lead the IRS and policymakers to establish complicated procedural hurdles and documentation requirements intended to screen out potentially ineligible applicants and prevent improper payments. This approach may be based on the assumption that if the taxpayer qualified for the benefit, he or she would produce the required documentation and navigate whatever procedures the IRS establishes – an assumption that may be appropriate when dealing with many high-income taxpayers, but not when dealing with less affluent taxpayers who are more often the beneficiaries of social programs.

Procedural hurdles can unnecessarily burden both the IRS and the intended beneficiaries of the program, frustrating the goal of efficiently delivering benefits.123 Accordingly, to structure such a program effectively it is important for policymakers to understand the needs of the target population as well as how much complexity they can reasonably handle. In addition, it is important for the IRS to evaluate the effectiveness of the program based in part on whether it has achieved its intended purpose of delivering benefits, rather than simply withholding or recovering benefits from persons who do not appear to be eligible because they did not satisfy the procedural hurdles.

1. The First-Time Homebuyer Credit Has Complicated Procedures Intended to Address Improper Payments.

Traditionally, spending programs such as Food Stamps or the Section 8 Housing Choice Voucher Program have screened out ineligible claimants on the front end at a high administrative cost with relatively low participation rates.124 By contrast, the IRS relies on voluntary assessment through the filing of a tax return, so the tax return

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123 For a more in-depth discussion, see National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 101-119 (Research Study: Evaluate the Administration of Tax Expenditures) and National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75-104 (Research Study: Running Social Programs Through the Tax System).

124 See David A. Weisbach and Jacob Nussim, The Integration of Tax and Spending Programs, 113 Yale L.J. 955, 1001 (2004) (observing that integration of provisions such as Food Stamps and the EITC into the tax system can enhance “administrative efficiency by reducing bureaucratic costs”).
essentially serves as the “application” for benefits provided through the tax system. For that reason, tax benefits such as the First-Time Homebuyer Credit (FTHBC) generally have low administrative costs and relatively high participation rates but may carry a higher risk of payments to ineligible claimants.125 Thus, if policymakers are more concerned with improper payments than with low participation, a direct spending program may be a better vehicle for delivering benefits, particularly if agencies other than the IRS have relevant expertise.

Nonetheless, to reduce the risk of improper payments, the FTHBC law requires taxpayers to attach a “settlement statement” to their returns to substantiate eligibility before they obtain the credit.126 Requiring taxpayers to include such substantiation up front, however, counters the efficiency and policy reasons for using the tax system to administer this particular social benefit, as follows:

- **Up-front substantiation is burdensome for taxpayers and the IRS.** When Congress requires up-front substantiation, the IRS may have to process submissions manually. When it does not receive required substantiation documents, it has to send out letters, which trigger further communications to which it has to respond, draining IRS resources and burdening taxpayers. Moreover, in the case of the FTHBC, the determination regarding what form of documentation is acceptable is surprisingly complicated and falls outside of the IRS’s core area of expertise. For many homeowners, a form known as HUD-1 issued by the Department of Housing and Urban Development will satisfy the requirement. Nonetheless, many homeowners will not have a signed HUD-1.127 Consequently, IRS personnel who receive FTHBC returns have to interpret sundry documents to determine whether they constitute a “settlement statement.”

- **Up-front substantiation frustrates IRS efforts to meet congressionally mandated goals for e-filing.** The IRS has a congressionally-mandated goal of increasing the rate at which taxpayers file returns electronically (i.e., e-filing).128 Even if taxpayers can produce acceptable FTHBC

125 See Weisbach and Nussim, 113 Yale L.J. 955, 1010 (2004) (“The EITC has a high participation rate but also a high overpayment rate. These facts are likely due to the lack of a precertification process.”); Anne L. Alstott, The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform, 108 Harv. L. Rev. 560, 564-65, 589 (1995) (observing that “the EITC and other tax-based transfers can enhance administrative efficiency by reducing bureaucratic cost” and identifying “the potential for noncompliance inherent in a tax-based program”).


127 See, e.g., IRS Instructions for Form 5405, First-Time Homebuyer Credit and Repayment of the Credit 2 (March 2011) (acknowledging that not all taxpayers will have a signed HUD-1).

documentation, the requirement to attach it to the return may preclude them from filing electronically, frustrating IRS efforts to reach its goal.129

- **By increasing taxpayer burden, up-front substantiation may reduce taxpayer participation, a primary benefit of running it through the tax code.** As noted above, special tax benefits such as the EITC and FTHBC are intended to have low administrative cost and relatively high participation rates but a higher risk of payments to ineligible claimants. These benefits arise primarily because taxpayers are not faced with burdensome up-front substantiation requirements. By requiring up-front substantiation, we lose these benefits, making the FTHBC no better than a direct spending program in this respect. Even worse, taxpayers and the IRS are still faced with the burdens associated with verifying FTHBC eligibility on the back-end through audits.

- **There is little justification for imposing an up-front substantiation requirement for refundable credits like the FTHBC while not imposing it for deductions.** Overstatement of a refundable credit is economically equivalent to underpayment of tax for any other reason. Other Schedule A itemized deductions often result in greater audit adjustments than some of the more common refundable credits. For example, the average 2009 audit adjustments for the child tax credit, EITC, and FTHBC were $3,531, $3,397, and $3,041, respectively, as compared to $8,376, $6,749, and $6,155 for charitable deductions, medical expenses, and the AMT.130 Moreover, approximately 55 percent ($109 billion) of the individual underreporting gap (totaling approximately $197 billion) came from understated net business income, such as unreported receipts and overstated expenses for self-employed taxpayers.131 By contrast, only about nine percent ($17 billion) came from overstated tax credits.132

129 To reduce erroneous FTHBC claims, TIGTA recommended that the IRS require taxpayers to provide third-party documentation supporting the purchase of a home. TIGTA, Ref. No. 2009-40-142, The 2009 Filing Season Was Successful, Despite Significant Challenges Presented by the Passage of New Tax Legislation (Sept. 2009). The IRS disagreed with the recommendation because it would burden taxpayers and prevent up to two million taxpayers from e-filing. Id.


131 Id.

132 IRS, Tax Gap Map for Year 2001 (Feb. 2007). Although the overall net misreporting percentage is significantly higher for credits (at 26.3 percent) than for deductions (at 5.4 percent) in the aggregate, it is even higher for every other item that is not subject to information reporting (ranging from 51.3 percent for rents and royalties to 72 percent for nonfarm proprietor income), and may also be higher for certain specific deductions that the IRS does not disaggregate and report separately. Id. Moreover, a significant amount of EITC payments that the IRS believes to be improper may, in fact, be situations where the IRS could not distinguish between compliance and noncompliance because the taxpayer “flunked the audit,” as a result of communication difficulties, as discussed below.
Accordingly, the National Taxpayer Advocate does not believe that noncompliance is necessarily more prevalent because of a special tax benefit’s design as a refundable credit than any other type of special tax benefit.

- **Up-front substantiation requirements do not effectively eliminate fraud.** As TAS previously reported, websites have offered fake but convincing settlement statements. In view of the contradictory policies contained with the FTHBC, we have observed that a housing agency would be better positioned to administer it than the IRS.

**Recommendation:** We recommended that Congress not run a special benefit designed like the FTHBC through the tax system again.

2. **The Earned Income Tax Credit Is Legally Complicated, and Also Has Complicated Procedures Intended to Address Improper Payments.**

Generally, the amount of the EITC increases as earned income increases up to a maximum credit of $5,666, creating an incentive for low income taxpayers to work. Although aimed at low income taxpayers, the EITC is very complicated. The credit increases if a worker has one, two, or three qualifying children, but is disallowed if the worker has more than $3,100 of investment income. The EITC phases out at an income ceiling of $48,362 (for a married couple filing jointly with three or more qualifying children), while other requirements govern eligibility and computation. Thus, a low income taxpayer may be asked to both determine and

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134 See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 102-03 (Research Study: Running Social Programs Through the Tax System). If the FTHBC is to remain a tax credit, we have recommended that policymakers reconsider the design of the documentation requirement. See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 100-103 (Administrability Problems Specific to the First Time Homebuyer Credit).

135 See IRC § 32(f); IRS Pub. 596, Earned Income Credit 45 (2010).


137 See IRC §§ 32(b) (increasing EITC amount based on number of children), and 32(i) (denying EITC to workers who have excessive income-producing investment assets).

document income, investment income, and his or her relationship to and the residency of himself or herself and one or more children.\textsuperscript{139}

The relationship and residence requirements are particularly complicated and difficult to document. Under the relationship requirement, the taxpayer generally may claim the EITC with respect to a child who is his or her son, daughter, stepchild, foster child, or a descendant of any of them (e.g., a grandchild), or a child who is a sibling, stepsibling, or half-sibling of the taxpayer, or a descendant of any of them (e.g., a nephew or grandnephew).\textsuperscript{140} Under the residence requirement, a taxpayer generally may claim the EITC only with respect to a child who lives with the taxpayer for more than half the calendar year (i.e., six months plus one day).\textsuperscript{141} As a result of this complexity and the procedural problems involved in requiring a low income taxpayer to document his or her residency and relationship to various children, the most frequent reason that the IRS rejects an EITC claim is because the taxpayer did not establish relationship or residency to the IRS’s satisfaction.\textsuperscript{142}

\textit{Recommendation:} As noted above, we recommended separating the work portion of the EITC from the portion attributable to family size, and then consolidating the latter with the other family-related tax benefits (i.e., filing status, dependency exemption, child tax credit, and child care credit) into a refundable credit that also does not phase out at higher income levels.\textsuperscript{143} If implemented properly, this proposal should reduce the incentives for fraud (i.e., the relatively high EITC amount for low income taxpayers) and simplify the substantiation process for taxpayers claiming the worker credit.\textsuperscript{144} The worker credit could be easily verified through income reporting, leaving the more difficult family status eligibility verification to a separate family credit.\textsuperscript{145}


\textsuperscript{140} See IRC § 152(c)(2).

\textsuperscript{141} See IRC § 152(c)(1)(B).

\textsuperscript{142} See IRS, \textit{Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns}, at 13 (Feb. 28, 2002).


Running special benefit programs through the tax code has both advantages and disadvantages. To deliver special benefits—whether to individuals or businesses, rich or poor—the IRS may need expertise different from what it has, and definitely will need service skills. For example, effective administration of the EITC requires employees with skills and a mindset more like those of a case worker than an enforcement official. Recently, legislation has enacted a health-care credit for small business, which in turn may require skills for educating and serving specific small business market segments. While the IRS’s SB/SE Division currently focuses on the small business market segment, there are significant differences between agencies that provide benefits or services and agencies that police noncompliance in terms of culture, mindset, and the skill sets and training of their employees. If the IRS is to perform both roles effectively, it must have the right mission and funding dedicated to this benefit delivery function. Administering special benefit programs is placing significant strains on the IRS’s limited resources and requiring the IRS to perform tasks that go well beyond its current mission statement to “[p]rovide America’s taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.”

Recommendation: In view of the complexity that special tax benefits add to tax administration, we have recommended that the IRS revise its mission statement to reflect two distinct administrative roles of traditional tax collection and delivery of special benefits, an effort which should also include the following steps: (1) revising Revenue Procedure 64-22 to include the IRS’s responsibility as benefit administrator; (2) creating a program office and new deputy commissioner position to provide strategic direction for all benefits programs; and (3) conducting a comprehensive evaluation of the administration of previous and existing special tax benefits to aid in the planning and implementation of existing and future programs.

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Policy Statement 1-1, IRM 1.2.10.1.1 (Dec. 18, 1993).


See National Taxpayer Advocate 2010 Annual Report to Congress 15 (Most Serious Problem: The IRS Mission Statement Does Not Reflect the Agency’s Increasing Responsibilities for Administering Social Benefits Programs).
VI. When Complexity Creates Opportunities for Abuse, Excessive Reliance on Enforcement to Address the Abuse Burdens and Alienates Taxpayers Who Are Trying to Comply.

While complexity creates opportunities for abuse, it also increases the likelihood that the vast majority of taxpayers who are trying to comply or who will go to great lengths to comply will be confused and make inadvertent errors. Thus, addressing the problem by focusing primarily on enforcement may be short sighted and resource intensive, particularly if the provision is so complicated that it is difficult for the IRS to distinguish between compliance and noncompliance. For example, as discussed above, the EITC is a relatively complex tax credit. Its complexity may create opportunities for abuse, as evidenced by a significant overclaim rate. At the same time, that measure of non-compliance may mask significant confusion by low income taxpayers.

In particular, TAS research found that in 67 percent of EITC audit-reconsideration cases where we called the taxpayers three or more times, the taxpayers were entitled to virtually all of the EITC that they had claimed, but that they had “flunked the IRS audit process.” In the original audit, the IRS had erroneously assumed that certain taxpayers were not eligible for the EITC. Instead, those low income taxpayers had been confused by IRS audit procedures, notices, and documentation requirements. When TAS staff explained the requirements, reported eligibility increased. Notably, the percentage of taxpayers who received EITC increased in direct proportion to the number of telephone contacts that TAS initiated. If this case study is any indication, enforcement approaches, such as increasing audits or documentation requirements, may be the wrong response to complexity.

A. Excessive Reliance on Automated Enforcement Tools, Such as “Math Error Authority,” Burdens and Alienates Taxpayers Who Are Trying to Comply.

Another approach increasingly used to address apparent noncompliance is the IRS’s so-called “math error” authority. Pursuant to this authority, the IRS is authorized to make summary assessments of tax to correct arithmetic mistakes and the like.

150 See TIGTA, No. 2011-40-023, Reduction Targets and Strategies Have Not Been Established to Reduce the Billions of Dollars in Improper Earned Income Tax Credit Payments Each Year 1 (Feb. 7, 2011) (“The FY 2009 EITC improper payment rate is estimated to be between 23 percent to 28 percent or $11 billion to $13 billion in EITC improper payments each year.”).

151 National Taxpayer Advocate 2004 Annual Report to Congress, vol. 2, at i and 9 (EITC Audit Reconsideration Study) (relating to a random sample of more than 900 EITC audit reconsideration cases closed between July 1, 2002, and January 31, 2003). The term “audit reconsideration” refers to the process the IRS uses to reevaluate the results of a prior audit where the taxpayer disagrees with the original determination and provides additional information that was not previously considered. See IRM 4.13.1.2 (Oct. 1, 2006).

152 See id. at 10.

153 See IRC § 6213(b), (g).
Math error authority can help prevent taxpayers from inadvertently (or fraudulently) receiving tax benefits for which they are not eligible, provided unambiguous information on the face of the return, or other reliable government database, shows they are clearly ineligible. Indeed, this is how math error authority was originally supposed to be used.\footnote{154 See National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: Math Error Authority).} Moreover, there are instances where additional math error authority would help reduce both inadvertent and fraudulent claims. For example, the American Opportunity Tax Credit provides for a maximum annual credit of $2,500 for qualified post-secondary education expenditures.\footnote{155 See IRC § 25A(i).} Up to 40 percent of the credit is refundable. Because the credit is available only for the first four years of a student’s post-secondary education and because the number of years claimed for each student is apparent on the face of the return, additional math error authority would enable the IRS to stop the improper payment of capped claims with minimal resources.\footnote{156 See Improper Payments in the Administration of Refundable Tax Credits, Hearing Before the H. Subcomm. on Oversight, Comm. on Ways and Means (May 25, 2011).} A close review of recently enacted tax expenditures might identify additional candidates for math error authority that would protect both the taxpayer and the public fisc from improper payments without eroding vital taxpayer rights or significantly increasing taxpayer burden.

In view of increasingly complex eligibility requirements for tax benefits, however, the IRS is straining to apply math error authority to correct discrepancies between information shown on the face of the return and external data (\textit{i.e.}, data not shown on the face of the return) that is not necessarily reliable.\footnote{157 Under existing math error procedures, we believe the IRS could do more to resolve discrepancies by consulting readily available research tools before making math error adjustments and that doing so would save resources and reduce taxpayer burden. See National Taxpayer Advocate 2011 Objectives Report to Congress 70-71.} For instance, in the case of the FTHBC discussed above, omission of the required settlement statement is subject to summary assessment of the tax liability resulting from the denied credit.\footnote{158 See IRC § 6213(g)(2)(P)(iii).} When a settlement statement may take many forms that an IRS employee may not recognize at first, we do not believe summary assessment is appropriate. More generally, if the IRS needs to rely on external data (other than reliable data from a government database) to make a determination, it should conduct a standard audit, rather than making a summary assessment using the math error process, particularly when the denial involves an inherently qualitative judgment.\footnote{159 See National Taxpayer Advocate 2002 Annual Report to Congress 185 (Legislative Recommendation: Math Error Authority).} In sum, complexity in the tax law requires complex administration; summary denial of tax benefits abridges taxpayers’ rights to present their particular facts, and in some cases, inevitably delays or denies them benefits to which they are entitled.
**Recommendation**: We recommended that math error authority not be expanded beyond inconsistencies in numerical or quantitative items included on the face of the return or a reliable government database, unless the Treasury Department has first conducted a detailed analysis of the impact of such an expansion on taxpayer rights and burden.160

**B. Excessive Reliance on Automated Enforcement Tools, Such as the “Lien Filing Threshold” that Causes the IRS to File Liens that Do Not Attach to Anything, Burdens and Alienates Taxpayers Who Are Trying to Comply.**

A notice of federal tax lien (NFTL) filing can be a useful tool in a comprehensive and balanced strategy to increase tax compliance. An NFTL protects the government’s interests in a taxpayer’s property against subsequent purchasers, secured creditors, and junior lien holders when past due taxes are owed.161 However, an NFTL severely damages the financial welfare of the affected taxpayer, and may reduce federal revenue and tax compliance for years to come.162 Specifically, it significantly harms the taxpayer’s credit and thus negatively affects his or her ability to obtain financing, find or retain a job, secure affordable housing or insurance, and ultimately

160 See id. at 186. In the National Taxpayer Advocate 2002 Annual Report to Congress we described this report as follows:

This report, prepared by the Department of Treasury in consultation with the National Taxpayer Advocate, should analyze the specific need for such expansion, the alternative methods for resolving the identified need, the projected revenue and cost savings attributed to the expansion of math error notices, and the alternative methods identified. Further, the report should include an analysis, prepared by the National Taxpayer Advocate, of the impact on taxpayer rights of such expansion. This taxpayer rights impact statement should identify the substantive and procedural rights that may be affected by the expansion, and provide an analysis of the taxpayer segments most likely to be impacted by the proposed expansion. It should also include a discussion of the potential resource consequences for both the taxpayer and the IRS in trying to address and resolve post-assessment matters flowing from the expanded math error authority. Id.

161 IRC §§ 6321 and 6323.

pay the outstanding tax debt.\textsuperscript{163} In this way, it can also hamper the taxpayer’s ability to pay past, present, and future tax liabilities.\textsuperscript{164}

Given the serious damage that an NFTL filing can do to the taxpayer and the IRS’s ability to collect, we believe the decision regarding whether to file an NFTL should be made on a case-by-case basis. Yet, the IRS files many NFTLs systemically, pursuant to “business rules” that require automatic lien filing or a lack of substantive human review under certain circumstances when the liability exceeds the “lien filing threshold.”\textsuperscript{165} Under current policy, the IRS generally requires NFTL filing without considering the existence of assets, the likelihood that the taxpayer will acquire assets during the remaining statute of limitations period, or the taxpayer’s history of compliance.\textsuperscript{166} In other words, the IRS may automatically file an NFTL even if the taxpayer is doing everything reasonably possible to comply and repay his or her tax debts and has no equity in assets to which a lien could attach.

The IRS’s approach has harmed taxpayers while failing to improve revenue collection results. NFTL filings have increased by over 550 percent in the past 11 years, from about 168,000 in FY 1999 to nearly 1.1 million in FY 2010.\textsuperscript{167} During the same period, the inflation-adjusted “collection yield” (in 2010 dollars) has essentially remained flat, increasing slightly from $29.56 billion in FY 1999 to $29.83 billion in FY 2010 (an increase of less than one percent).\textsuperscript{168}

Further, a study conducted by TAS Research showed that most of the revenue collected from taxpayers against whom liens had been filed was not attributable to the lien.\textsuperscript{169} In cases where the source of a payment was coded or could be

\textsuperscript{163} On average, a lien filing reduces a taxpayer’s credit score by 100 points. Written response from Vantage Score® (Sept. 17, 2009). The impact of the NFTL filing is greatest upon the initial filing and diminishes over time.

\textsuperscript{164} \textit{See, e.g.}, IRC § 6323(d) (providing that security protection only extended to the lender for disbursements made within 45 days after the filing of the NFTL, or until the lender is provided actual notice of the NFTL); IRC § 3505(b) (holding a lender providing funds for the ongoing operation of a business potentially liable for unpaid withholding taxes if certain criteria are met).

\textsuperscript{165} \textit{Automated Collection System (ACS) Customer Service Activity Reports (CSAR), FY 2009 BOD report}. \textit{See also} E-mail from IRS subject matter expert (Nov. 2, 2009); IRM 5.19.5.3.7 (Feb. 28, 2011); IRM 5.19.5.5.7 (Feb. 28, 2011).

\textsuperscript{166} IRM 5.19.4.5.2 (May. 20, 2011); IRM 5.12.2.4.1 (Apr. 15, 2011).

\textsuperscript{167} IRS, \textit{IRS Data Books, Table 16, Delinquent Collection Activities, 1999 - 2010}.

\textsuperscript{168} IRS, \textit{IRS Statistics of Income (SOI) Data Books, Table 16, Delinquent Collection Activities, 1999 and 2010}. The inflation adjustment was calculated using the Bureau of Labor Statistics calculator available at \texttt{http://www.bls.gov/data/inflation_calculator.htm} (last visited June 2, 2011). The TY 1999 and 2010 revenue yield figures are $29.56 billion and $29.83 billion, respectively, in nominal dollars. This is the same as inflation adjusted dollars for TY 2010 because the inflation adjustment converts all figures to 2010 dollars.

\textsuperscript{169} National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 1-18 \textit{(TAS Research Study: The IRS’s Use of Notices of Federal Tax Lien)}. TAS reviewed nearly 1.9 million transactions involving about 270,000 individual taxpayers who first incurred new balance-due liabilities during tax
determined through analysis (about 48 percent of the payments that occurred during the period studied), TAS found that more than 80 percent of all revenue collected and 95 percent of all payments did not result from the lien filings and would have been collected anyway.\textsuperscript{170} Moreover, there is no evidence that NFTL filings improve future compliance.\textsuperscript{171}

\textbf{Recommendation:} We have recommended legislation to require that prior to filing an NFTL, the IRS review all the taxpayer’s circumstances (including the existence and value of assets, the taxpayer’s overall financial situation, the taxpayer's compliance history and reasons for noncompliance, and the existence and amount of non-tax debt) and make a determination, weighing all facts and circumstances, that (i) the NFTL will attach to property, (ii) the benefit to the government of the NFTL filing outweighs the harm to the taxpayer, and (iii) the NFTL filing will not jeopardize the taxpayer’s ability to comply with the tax laws in the future.\textsuperscript{172}

\textbf{VII. The IRS’s Failure to Offer Simple and Reasonable Payment Alternatives to Taxpayers Who Cannot Pay in Full Leaves Delinquencies Uncollected and Burdens and Alienates Those Who Are Trying to Comply.}

The IRS’s general approach to delinquent taxpayers has been one of neglect followed by unrealistic inflexibility. At the conclusion of FY 2010, over 5.5 million unresolved IRS collection notices went unpaid and progressed to Taxpayer Delinquent Account (TDA) status, meaning the accounts (or tax modules) remained unpaid.\textsuperscript{173} At the end of FY 2010, approximately 3.3 million of these accounts, year 2002 (and who had no previous unpaid balances due at that time) and against whom NFTLs were filed in subsequent years. Taxpayer payment behavior was tracked through the 13\textsuperscript{th} week of 2009.

\textsuperscript{170} See National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 4. Most commonly, the IRS collects past tax debts by “offsetting” (i.e., not paying) refunds for which taxpayers otherwise qualify in future years.

\textsuperscript{171} TAS is conducting its own study of the impact of NFTL filings on future tax compliance. The objectives of this study are: 1) to determine whether any amounts of payments are likely attributable to the NFTL; 2) to determine the effect of the NFTL on future payment compliance; 3) to determine the effect of the NFTL on future filing compliance; and 4) to determine whether the NFTL is associated with a decline in future income. National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 89-101 (Estimating the Impact of Liens on Taxpayer Compliance Behavior: An Ongoing Research Initiative).

\textsuperscript{172} See National Taxpayer Advocate 2009 Report to Congress 357-364. The Targeted Tax Lien Act of 2010 would require the IRS to take the steps we have recommended. H.R. 6439, 111th Cong. (2010). In addition, TBOR 2010 would require individualized lien determinations and supervisory review before the IRS can file a notice of federal tax lien. S. 3215, 111th Cong. (2010); H.R. 5047, 111th Cong. (2010).

\textsuperscript{173} IRS, Collection Activity Report, NO-5000-2, Taxpayer Delinquent Account Cumulative Report (Oct. 2010). For purposes of this discussion an “account” means one tax period or “module.” Thus, a single taxpayer could have a liability with respect to more than one module or account. These 5.5 million modules likely represent about 2.2 million taxpayers because, on average, there are about 2.5 modules per taxpayer. \textit{Id.}
involving about $46.2 billion were assigned to the collection “queue.”174 These cases tend to sit for years in the queue, accruing interest and penalties, and therefore becoming more difficult for taxpayers to resolve and for the IRS to collect. At the end of FY 2010, approximately 80 percent of the IRS’s total inventory of open TDAs involved tax periods from the years 2007 and prior.175

Because the IRS generally collects practically nothing on debts older than three years, it is unlikely to collect very much on these TDAs.176 Yet, the IRS’s collection policies present significant barriers to taxpayers who try to reach fair and reasonable payment arrangements, particularly if they cannot pay in full. For example, in determining a taxpayer’s ability to pay a delinquent federal tax debt, the IRS does not make allowance for certain other debts the taxpayer faces, such as credit card bills, delinquent state or local taxes, court-ordered payments, excessive mortgage expenses, or any bill the taxpayer is not current in paying, including student loans, medical bills, and even secured debts. However, other creditors will continue to press the taxpayer to repay these debts. For example, a state tax agency does not stop garnishing a paycheck and a credit card collection company does not stop calling just because the taxpayer has committed to an IRS payment plan. Thus, the IRS’s unwillingness to allow for payments to other creditors is often unrealistic.

Indeed, a 2009 TAS Research study examined a group of individual taxpayers who had no prior unpaid tax delinquencies, but failed to pay taxes assessed in 2002 (i.e., following a previous recession).177 The study found that at least half of the taxpayers who declared bankruptcy would have appeared to be “able to pay” based on the IRS’s collection financial analysis, yet the fact that they declared bankruptcy suggests they could not.178 It concluded the IRS overestimates these taxpayers’ ability to pay because it fails to consider their disallowed debts.

Given the IRS’s unrealistic financial analysis, it is perhaps unsurprising that in FY 2010, in the midst of an economic downturn, the IRS only accepted 13,886 offers in compromise (OIC) and 40,461 partial payment installment agreements (PPIA) – payment plans that will not repay the delinquency in full before the collection statute

174 Id. According to the same IRS report, these 3.3 million accounts represent about 949,200 taxpayers.
175 Id.
176 IRS/Booz Allen Hamilton, SB/SE Collections Quick Hits Approach and Preliminary Findings 30 (Mar. 27, 2001); IRS, Automated Collection System Operating Model Team, Collectibility Curve (Aug. 5, 2002).
expiration date.\textsuperscript{179} Moreover, the IRS only accepted approximately 95,000 installment agreements (IAs) on business-related tax delinquencies, which generally involve small business taxpayers.\textsuperscript{180}

In addition, despite the economic downturn, less than four percent (245,660) of the TDAs handled by the IRS’s Automated Collection System (ACS) were reported as uncollectible due to economic hardship.\textsuperscript{181} By comparison, the IRS issued approximately 3.6 million levies and 1.1 million liens during FY 2010, largely pursuant to automated procedures discussed above.\textsuperscript{182} Further, for 2008 through 2010, while the global recession was taking hold, the ratio of levies to taxpayer case receipts in ACS was 86 percent.\textsuperscript{183} On the other hand, by one estimate ACS personnel used less than three percent of their “direct time” to contact taxpayers by making outbound calls.\textsuperscript{184} While liens and levies may be necessary to collect from taxpayers who truly “won’t pay,” even though they can, IRS collection program results – leaving so many accounts unresolved for so long – suggests that an excessive focus on automated liens and levies, in lieu of addressing delinquencies earlier and offering reasonable payment alternatives, will not be successful in most cases.

Recently, the IRS has publically announced its intention to be more flexible in working with taxpayers in resolving outstanding tax debts.\textsuperscript{185} Moreover, it has been working with TAS to improve various aspects of its collection programs. For example, it recently increased the “thresholds” for filing NFTLs, began to withdraw NFTLs in more situations, and has expanded its use of pilot “streamlined” offer in compromise procedures. The IRS is on track to increase offer acceptances in FY 2011 by about 59 percent.\textsuperscript{186}

\begin{flushleft}
\textsuperscript{180} Id.
\textsuperscript{181} IRS, Collection Activity Report, NO-5000-2, \textit{Taxpayer Delinquent Account Cumulative Report} (Oct. 2010).
\textsuperscript{182} IRS, Collection Activity Report, NO-5000-C23, \textit{Collection Workload Indicators} (Mar. 2011).
\textsuperscript{183} IRS, Collection Activity Report, NO-5000-2, \textit{Taxpayer Delinquent Account Reports} (Oct. 2010); IRS, Collection Activity Report, NO-5000-23, \textit{Collection Workload Indicators} (Oct. 2010).
\textsuperscript{184} See TIGTA, Ref. No. 2010-30-046, \textit{More Management Information Is Needed to Improve Oversight of Automated Collection System Outbound Calls} 3 (Apr. 28, 2010). The current ACS staff spends approximately 70 percent of its time taking inbound calls, so outbound contact attempts are often de-prioritized. \textit{Id.} See also IRS, \textit{Collection Process Study} 98 (Sept. 30, 2010).
\textsuperscript{186} IRS, Collection Activity Report, NO-5000-108, \textit{Monthly Report of Offer in Compromise Activity} (June 2011) (showing that the IRS accepted 12,704 offers during the eight-month period ending in May 2011); IRS, Collection Activity Report, NO-5000-108, \textit{Monthly Report of Offer in Compromise Activity} (Oct. 2010) (showing that the IRS accepted 7,994 offers during the eight-month period ending in May 2010).
\end{flushleft}
These changes are an important step in the right direction. We are hopeful that the IRS is beginning to recognize that its collection function’s pre-existing one-size-fits-all approach that treats all delinquent taxpayers as if they “won’t” pay seems more likely to perpetuate noncompliance than to foster voluntary compliance. The government needs to offer a taxpayer who cannot pay in full realistic options to pay what he or she can, so that voluntary compliance is practical. Not surprisingly, the 2009 TAS study (cited above) found that about 74 percent of those taxpayers with TDAs had one or more subsequent tax delinquencies or unfiled returns, even though they had no outstanding balance due prior to 2002. Thus, although the study did not definitively identify the causes of subsequent noncompliance, it confirms that the IRS’s current approach fails to promote future compliance for an extraordinarily large percentage of these taxpayers. As noted above, TAS is also conducting a study of the impact of NFTL filings on future tax compliance.

VIII. Conclusion

Complexity promotes tax noncompliance both by increasing opportunities for inadvertent error and by creating loopholes, which may allow well-advised taxpayers to pay less than similarly situated taxpayers who are not so well advised. These loopholes also create a perception that the tax system is not fair, a view that may be used to justify “fudging” a bit here and there to even things out. Complexity also makes compliance more difficult for the vast majority of taxpayers who are trying to comply and increases the risk that they will be subject to penalties or other automated processes, such as unjustified math error assessments, automated lien filings, and similar procedures that may burden and alienate them. The IRS Collection function’s longstanding approach of first ignoring delinquencies and then applying complicated and unrealistic financial analyses may also alienate taxpayers who have delinquencies but would like to comply.

The limited research available supports what common sense would seem to suggest – namely, that penalizing, burdening and alienating taxpayers who have reasonably tried to comply is not only bad for the tax system but is also likely reduce

187 See, e.g., Joshua D. Rosenberg, The Psychology Of Taxes: Why They Drive US Crazy, And How We Can Make Them Sane, 16 Va. Tax Rev. 155 (Fall 1996). See also, Bryan T. Camp, The Failure of Adversarial Process in the Administrative State, 84 Ind. L. J. 58, 68, 76-77 (Winter 2009) (acknowledging that treating taxpayers who can’t pay as if they can likely wastes resources, undermines confidence in government, and ultimately reduces voluntary compliance, but nonetheless excusing the IRS’s bulk-processing approach on the basis that the IRS is “trying to collect millions of unpaid accounts with only a few thousand employees.”).

188 National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 29. However, TAS could not determine how many of these taxpayers actually had a filing requirement.

the public's willingness to comply rather than increase it, potentially increasing the tax gap.

Tax simplification could go a long way toward improving compliance and reducing the tax gap. Ideally, I believe Congress should simplify the tax code through broad-based tax reform, but if comprehensive reform is not imminent, I urge Congress to enact some of the many narrower simplification recommendations we have proposed over the years, many of which I have summarized in this statement.

In addition, I believe we should generally avoid adopting enforcement procedures and penalties that alienate and burden taxpayers. If the goal of such procedures and penalties is to reduce the tax gap, we should only adopt them if objective data and research suggest that they will, indeed, achieve that goal.

190 In the National Taxpayer Advocate 2010 Annual Report to Congress, we identified the complexity of the tax code and the confusion and distrust it engenders as the number one most serious problem facing taxpayers – and the IRS. We titled that section “The Time for Tax Reform Is Now,” because while there has been a lot of talk of tax reform in recent years, experience has shown that it will require a sustained, bipartisan effort – with the support of an engaged public – to make tax reform a reality.

191 These include proposals to simplify education savings tax incentives, retirement savings tax incentives, S corporation election procedures, worker classification determinations, the AMT (which we believe should be eliminated), family status provisions, and tax provisions that sunset or phase-out, as described above.

192 While such research is challenging, it is not impossible. As noted above, TAS is researching the impact of automated lien filings on future compliance.