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# COMPLEXITY AND THE TAX GAP: MAKING TAX COMPLIANCE EASIER AND COLLECTING WHAT IS DUE

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

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# COMPLEXITY AND THE TAX GAP: MAKING TAX COMPLIANCE EASIER AND COLLECTING WHAT IS DUE

**THURSDAY, JUNE 28, 2011**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:13 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Conrad, Bingaman, Wyden, Carper, Hatch, Snowe, and Thune.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; and Tiffany Smith, Tax Counsel. Republican Staff: Mark Prater, Deputy Chief of Staff and Chief Tax Counsel; Jim Lyons, Tax Counsel; and Bryan Hickman, Special Counsel.

## OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The hearing will come to order. I apologize to everybody for being a bit late. Senator Hatch and I had a little business to conduct. It was very helpful.

So we will now proceed with the hearing.

John F. Kennedy said, "To the extent that some people are dishonest or careless in their dealings with the government, the majority is forced to carry a heavier burden."

In today's tax code, the majority is carrying a heavy burden. It is a burden of hundreds of billions of dollars in taxes that are owed, but not paid. It is a burden that prevents us from building new schools or investing in cutting-edge scientific research. It is a burden that keeps us from paying off the debts we owe and reducing our deficits.

According to the latest IRS estimates, the number of tax dollars that are owed, but remain unpaid is $345 billion each year. And I might say that latest estimate was several years ago. That is not the most current, which, obviously, would reach a higher level.

This disparity is often referred to as the tax gap. Today, the tax gap equals nearly 20 percent of our forecasted deficit for this fiscal year. In short, the tax gap is more than $300 billion that we simply cannot afford to waste.

Part of the tax gap is the result of tax cheats who simply refuse to comply with the law, which increases the burdens on the rest

of us. But a portion is due to taxpayer confusion and unintentional errors, as well. We can certainly all agree that the tax code is extremely complex.

According to the IRS data, U.S. taxpayers and businesses spend more than 6 billion hours each year complying with the filing requirements of the Internal Revenue Code. As the Taxpayer Advocate's 2010 annual report states, if the hours Americans spend on tax compliance were instead spent on an industry, it would be one of the largest in the United States. Six billion hours is equal to the work of more than 3 million full-time employees.

Today's hearing will focus on issues of tax complexity and the tax gap, as well as the correlation between them.

Does confusion surrounding the complexities of the code lead to noncompliance? Can filers simply not figure out the law and how to comply with it? Or is the tax code so confusing because we have patched up loopholes and written new rules in an effort to prevent noncompliance?

First, we must ask why people fail to meet their tax obligations. Failure to comply can take three forms—underreporting the amount owed, underpaying the amount a taxpayer acknowledges is owed, and simply not filing at all.

Reports from the Government Accountability Office and the Joint Committee on Taxation have found there are two proven ways to reduce noncompliance—information reporting and withholding.

IRS research supports these findings, demonstrating that more taxes are paid with increased information reporting. When individuals and businesses provide substantial information about spending and income, the compliance rate is over 95 percent. When there is little or no information reporting, the compliance rate drops to 46 percent.

However, recent experience suggests that, in some areas, requiring American taxpayers to file additional information reports or withholding taxes is simply too burdensome.

Perhaps there are other solutions. For example, we should ask ourselves: Are there ways the IRS can harness new technology to do more with the same resources?

IRS Commissioner Shulman has proposed changes that would help the agency process tax data more quickly. This upgrade would ensure that the IRS has the information it needs to check the accuracy of tax returns immediately after they are submitted.

The IRS should identify errors instantly and reduce audits required down the road.

We should also consider ways the tax code is so complex that it actually discourages compliance. In 1987, a year after Congress passed major tax reform legislation, the instruction book for the primary individual income tax form was 56 pages; not light reading by any stretch of the imagination, but only 56 pages. In 2009, that figure had grown to 174.

This complexity makes it hard for taxpayers who honestly want to pay their taxes to figure out what they actually owe and, as a result, they often overpay or underpay. We must do more to understand the sources of the tax gap and compliance burdens so we can make progress uncovering new, creative solutions.

I have said before we should aim to reach a voluntary compliance rate of 90 percent by 2017. And to reach that goal, we need to think strategically.

How can we reform the tax system so we can collect the revenue that is due to the government in the most efficient manner possible? Do we need to tear down the current system and start from scratch? Can we keep the foundation? Do we just need a fresh coat of paint?

So let us consider solutions to close the tax gap that are both creative and efficient. Let us work to reform our code in a way that will help us collect more of the taxes owed, but not paid. And let us continue our work to make the tax code more fair and simple.

I would like to now turn to Senator Hatch.

[The prepared statement of Chairman Baucus appears in the appendix.]

## OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. Albert Einstein once said that the hardest thing in the world to understand is the income tax.

If there is one thing we can agree on as Republicans and Democrats, it is that Albert Einstein was a pretty smart guy. But with the Internal Revenue Code, he apparently met his match, and things are only getting worse.

Year after year, the tax code becomes more complex. This has contributed to two separate, but related problems. First, the complexity of the code undercuts compliance. Compliance with the tax code should not be a choose-your-own-adventure story, where the complexity of the code leaves citizens guessing their tax liability.

As Chief Justice John Marshall explained, the power to tax is the power to destroy. The power to tax is massive and intrusive. And I would have to say, given our constitutional commitment to personal liberty and the right to property, citizens should be personally well-aware of what their tax liability is.

The second issue, and one related to the code's complexity, is the tax gap. The tax gap is basically the difference between the amount of money that taxpayers legally owe and the amount that the government actually collects. The tax gap is the great white whale of deficit reduction. If only the government were able to collect what it is owed, our deficits would be reduced significantly.

For the 2001 tax year, the IRS estimated the tax gap to be $345 billion. Even after taking into account late payments and the IRS collections, that amount was estimated to be $290 billion. While the government should be able to reduce that amount significantly, it would be a mistake to put too much deficit reduction hope into the tax gap basket.

As an empirical matter, it is impossible to completely eliminate the tax gap. For example, some taxpayers legally owe a significant amount of money, but do not have the assets or income to pay off their tax debt. As the old saying goes, you cannot squeeze blood out of a turnip.

Yet, the tax gap debate has philosophical implications, as well. The government could close the tax gap entirely by putting IRS

agents in every family's living room and in every small business, but this is a price that liberty-loving people and their representatives are rightly unwilling to pay.

When it comes to compliance, I am convinced that the Federal Government is often its own worst enemy. As the code becomes more complex, compliance drops, and the tax gap increases.

Consider the impact of the health spending law alone on the tax code. Courtesy of this law, taxpayers with flexible spending accounts, accounts designated to provide user-friendly choices to patients, now need to go to their doctor to get a prescription for over-the-counter drugs like Prilosec.

Courtesy of this law, there is a 10-percent tax imposed if you use a tanning bed at a tanning salon, but not if you use one at your gym.

As this committee considers ways to address the tax gap, the saga over the health spending law's 1099 provision provides an instructive example. In the name of reducing the tax gap, Congress and the President imposed considerable burdens on individuals and businesses, redirecting vital resources toward additional government paperwork.

The burdens associated with the 1099 provision were so severe that even the provision's proponents were calling for its repeal soon after its enactment.

Outside of health care policy, we have other examples of the political and economic difficulty of addressing the tax gap. To reduce the tax gap, Congress passed a provision requiring a 3-percent withholding on government contractors. But, as a result of the compliance burdens that it has created, Congress has already delayed the effective date of this provision.

The matters being discussed today are ones that should inform our efforts at fundamental tax reform. As I have said before, I will be guided during that debate by the three criteria that President Reagan set out during the Tax Reform Act of 1986.

President Reagan explained that tax reform should promote economic growth, fairness, and simplicity. Tax reform is a priority of this committee, and I believe that President Reagan's three criteria are equally applicable today.

The tax gap implicates President Reagan's second criteria—fairness. When some taxpayers are paying what they owe, but their neighbors are not, that is unfair to the taxpayers who meet their obligations. In effect, it increases their share of the load.

Furthermore, lack of compliance undermines confidence in the tax system, in turn leading to less voluntary compliance. In short, when law-abiding taxpayers think that the complexity of the code rewards creative accounting and that some people are getting one over on the government, it will make them less likely to comply voluntarily.

Since our tax system collects the vast majority of its taxes through voluntarily compliance, maintaining and improving voluntary compliance is critical.

Now, President Reagan's third criteria of tax reform, simplification, is also relevant to today's discussion. Since the Tax Reform Act of 1986 was enacted, Congress has passed over 14,000 amendments to the tax code. Fundamental portions of the tax code, such

as the tax rates themselves, are set to expire at the end of 2012 unless Congress again acts to prevent a massive tax increase.

This, unfortunately, causes uncertainty for small business owners and others and causes Americans to invest less and hire fewer workers than if Congress were to provide long-term assurances that their tax rates will not increase.

The ever-increasing complexity of the tax code, which is only heightened by the temporary nature of many provisions, needs to be improved upon in tax reform. We need a tax code or a system with a more streamlined set of permanent provisions that is easier to comply with and less complex.

Mr. Chairman, thank you again. I look forward to hearing the testimony of the witnesses, and I appreciate your holding this hearing.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. Thank you, Senator, very much. I appreciate your leadership and your comments.

Our first witness is Michael Brostek, from the Government Accountability Office. Welcome again, Mr. Brostek.

Mr. BROSTEK. Thank you.

The CHAIRMAN. It is good to see you here. As many know, you are the director of Tax Policy and Administration at GAO.

The second witness is Ms. Nina Olson. Ms. Olson has served as National Taxpayer Advocate, Internal Revenue Service, since 2001; served very well. I see your name often as you stand up for taxpayers, and we appreciate that, and you, too, obviously, have testified several times. You testified well. That is why you are back again.

Next, David Kirkham. It is the first time, I think, Mr. Kirkham, we have had the pleasure of seeing you. You are the president of Kirkham Motorsports based in Provo, UT.

Finally, Ms. Kris Carpenter, owner and operator of Sanctuary Spa and Salon and two retail gift stores in Billings, MT. Welcome, Ms. Carpenter. You are a very solid, strong businessperson, small businessperson, and we very much appreciate your expertise and your perception of how the tax code affects you.

So let us all begin. Mr. Brostek, you are first. The usual and customary practice here is your statements are all submitted for the record and, meantime, just summarize your statement for about 5 minutes. Just do not pull any punches. Say what you want to say. Let it all hang out for about 5 or 6 minutes.

**STATEMENT OF MICHAEL BROSTEK, DIRECTOR, TAX POLICY AND ADMINISTRATION, GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC**

Mr. BROSTEK. We will do that.

The CHAIRMAN. Good.

Mr. BROSTEK. Chairman Baucus, Ranking Member Hatch, and members of the committee, thank you for inviting me to discuss the effect of tax code complexity on taxpayer burden, economic efficiency in compliance, as well as strategies to improve compliance and reduce the tax gap.

My statement focuses mainly on individual taxpayers and is based on previous GAO work and products.

I know I do not need to convince you the tax code is complex. You have just testified to that yourselves. For context, though, it is important to realize that complex provisions can have legitimate purposes.

In an era when complex sources of income exist in a global economy, simply defining income can be complex. Complex provisions are also used to target tax benefits to intended populations and to address areas of noncompliance.

But complexity does have costs. It creates burdens on taxpayers to understand complex requirements, to keep sometimes detailed records that may need to be retained far beyond the immediate tax year, and to revise their personal plans as tax laws continue to change.

Estimating the dollar cost of this burden is not easy. In 2005, we reviewed the existing studies and found that the lowest available compliance cost estimates for the personal and corporate income taxes combined was about $107 billion per year or about 1 percent of gross domestic product.

Economic efficiency costs of taxes are reductions in economic well-being, such as lost economic output or consumption opportunities. These, too, are difficult to estimate.

The two most recent comprehensive studies we found in 2005 estimated the efficiency costs of Federal taxes to be 2 to 5 percent of GDP annually in magnitude. The complexity of measuring income affects taxpayers who receive income from sources like capital gains, rents, and self-employment.

For example, capital gains or losses from selling stocks require individuals to have records of the date they bought and sold stock, purchase and sales prices, and resulting gains and losses. But they also need to determine whether events like stock splits occurred over the time that they owned the stock and take those events into account.

We estimated that for tax year 2001, over one-third of taxpayers with such income misreported it. Two-thirds of those misreporting underreported their income, while one-third overpaid.

Since then, Congress has taken steps to require dealers to track and calculate income for taxpayers on stock sales, a nice simplification.

Another significant source of complexity for individuals is determining eligibility for tax expenditures—tax benefits. Several tax provisions intended to help taxpayers with higher education expenses are an example.

For taxpayers, where data were available, we analyzed whether the taxpayers were selecting the provisions that gave them the most benefit. For tax year 2005, almost one in five did not use a provision at all when they were eligible. About 28 percent, 601,000 taxpayers, either did not use a provision or selected one that was not the best for them.

These taxpayers shortchanged themselves by hundreds of dollars. Although we cannot be sure these errors were due to complexity, it seems likely that many were.

We are not aware of any reliable estimates of how much of the tax gap is due to complexity, but certainly some significant portion is. Therefore, some strategies for reducing the tax gap may be effective if they address complexity. These strategies could include simplifying the code by, for instance, reducing the number of tax benefits that are available.

Another strategy focusing on complexity is providing high quality service to taxpayers through education and outreach, clear publications explaining tax requirements, and access to telephone assistance that provides accurate guidance.

A third complexity-related strategy is to make definitions consistent across tax provisions. Perhaps the key tax gap strategy is expanding information reporting. Sometimes information reporting, like the new requirement for basis reporting on stock sales, can reduce complexity for taxpayers. Information reporting is associated with very high levels of compliance.

Other tax gap reduction strategies would focus less on helping taxpayers deal with complexity and more on enforcing tax code requirements. Those strategies might include devoting more resources to IRS enforcement activities and performing more checks of compliance before tax refunds are mailed to taxpayers.

This concludes my statement, and I would be happy to answer any questions.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Brostek.

Ms. Olson, you are next.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Ms. OLSON. 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.

Most people do their best to comply with the tax laws and procedures, and the vast majority succeeds. They voluntarily pay their taxes in full and on time. The IRS collects only about 3 percent of tax revenue as a direct result of enforcement actions. Still, the IRS estimates that it does not collect about 14 percent of the taxes people owe.

To reduce the tax gap, we need to understand what is causing people to fail to comply. Certainly, a significant portion is due to deliberate underreporting, but much is not. In fact, available evidence suggests that considerable noncompliance, perhaps even most of it, results from inadvertent errors.

There is no doubt that the tax code, as it stands today, imposes excess compliance burdens. It is rife with complexity and special tax breaks, helping taxpayers who can afford expensive tax advice and discriminating against those who cannot.

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

This complexity also produces more complexity, creating a vicious cycle. In particular, complex laws create opportunities for abuse, which, in turn, spur more complex laws to stop the abuse, bur-

dening everyone, including the IRS and the majority of taxpayers who are trying to comply with the law in the first place.

When complexity creates opportunities for abuse, the IRS also tends to react with a broad enforcement-oriented approach that may further burden and alienate taxpayers who are trying to comply.

When complexity trips up taxpayers and they fall behind on their taxes, the IRS can and should do more to address delinquency more quickly and to offer simple and reasonable payment alternatives to taxpayers who cannot pay in full. Otherwise, complexity and the IRS's response to it will leave taxpayers who are trying to do the right thing unable to do so.

When the government's expectations are unrealistic, for example, when it expects that all taxpayers will be able to comply with very complicated rules or that taxpayers with no simple or realistic options for putting a delinquency behind them will suddenly become compliant, it is likely to be disappointed.

Let me give two other examples of the effects of tax complexity. First, considerable attention has focused on improper payments in the administration of refundable tax credits, particularly in the earned income tax credit, or EITC, and there has been pressure on the IRS to give higher priority to reducing EITC over-claims. Yet, many over-claims are not improper claims. Rather, they are claims the taxpayer is not able to prove under the law's definitional complexity and the IRS's narrow rules for acceptable documentation and taxpayer-unfriendly audit procedures.

In other words, tax law complexity has led to substantiation complexity that many low-income taxpayers cannot manage.

Economically, there is no difference between an overpayment of a refundable credit and a tax underpayment due to underreporting. Whether a taxpayer underreports gross income by an amount that leads to a $500 tax underpayment or the IRS pays a $500 tax credit to an ineligible taxpayer, the result is the same. The public treasury is out $500.

Improper EITC payments amount to only about 5 percent of the estimated tax gap, and taxpayers claiming the EITC are already subject to audits at more than twice the rate of the average individual taxpayer.

Thus, we must be very careful not to let the improper payment terminology cloud our perspective here and drive us to impose compliance rules that impose excessive burden on taxpayers and the IRS alike.

Measures such as expanded math error authority and requirements to submit documentation with tax returns may fall into this category.

On a related point, the IRS's increasing use of automated processes in place of human judgment and discretion in an effort to achieve efficiencies, particularly in the area of penalty administration, increases the risk that the government will act arbitrarily and capriciously; that is, without rationale. This, in turn, also undermines compliance.

In sum, I agree with the premise of this hearing: namely, that complexity promotes noncompliance and contributes to the tax gap. Although I support comprehensive tax reform, my written state-

ment identifies many areas where we could simplify the tax code and procedures even if comprehensive tax reform cannot be achieved in the near term.

Thank you.

[The prepared statement of Ms. Olson appears in the appendix.]

The CHAIRMAN. Thank you, Ms. Olson.

Mr. Kirkham, you are next.

**STATEMENT OF DAVID KIRKHAM, PRESIDENT, KIRKHAM MOTORSPORTS, PROVO, UT**

Mr. KIRKHAM. Chairman Baucus, thank you. Senator Hatch, thank you for inviting me here.

The CHAIRMAN. You may want to bring your microphone a little closer.

Mr. KIRKHAM. My microphone was not on.

The CHAIRMAN. It helps. Thanks.

Mr. KIRKHAM. Chairman Baucus, thank you for having me here today. Senator Hatch, thank you so much for inviting me to speak. And thank you to the other members of the committee who are here.

I would like to paint a picture today of what we are really talking about. What we are really talking about is jobs. And I do business all over the world, and I have seen jobs, and I have seen this road of tax complexity, and I have seen this road of tax gap and massive enforcement, and I have seen where it ends.

I have been to Russia, I have been to Poland—I own a factory in Poland—been to Greece, done business all over the world.

Can you pull that photograph up? This is a picture from a website. This is who I am, that is what I do. I make really cool cars. I went to Poland. I went to an old MIG fighter factory in Poland in 1995 and, when I got there, you know what? The lights were off. Men would stand behind their machines in the dark when they got to work at 7 in the morning. And they went home at 3 in the afternoon, and they stood there all day with nothing to do. That is what I walked into, and that is the road we are on.

In 2005, I had grown that company, along with my brother, to 75 employees in Poland. I was there—many of those guys I hired, I was there the day they were fired and let go from that factory, and I watched them walk out the door.

I watched them walk out in the cold. I watched them in the snow. I watched them get on their bicycles, and I watched them leave. Their government had failed them.

The next week, about 100 of them lined up at my doors and begged for work. That is what we are talking about. We are talking about massive unemployment. We are talking about who I am, what I want to do. I want to hire people. That is what I want to do.

But you know what? In 2005, I had had all I could take of socialism. And those 75 guys I had in Poland, I had to write down when I bought the lights, I had to write down when I turned them on, I had to write down when I pulled them out, I had to write down when I threw them away and where I disposed of them. And I could not take it anymore. I could not take all of the regulations. I could not take all the complexity. And I let them go, 66 guys.

I want to know who is the voice for 66 men that I let go. I turned them into very high-tech state-of-the-art equipment at my factory in Provo. That is what we are talking about. We are talking about jobs.

It is immoral for you guys to have laws that are so complex that I have to hire somebody to figure out how to comply with them. I have to hire tax attorneys, I have to hire accountants, I have to hire bookkeepers, and they cost a lot of money.

I spend $100,000 a year on this. Do you know how many jobs I could provide with that? Do you know how many other people I could employ?

Let us say I could hire two more guys. Maybe I could hire three more guys. Maybe those three guys would make me so much more productive and my brother and our company that I could hire another four, I could hire another five. And, yet, I cannot. Why? Because I have to spend my time figuring out how to pay the least amount of taxes possible.

I have a fiduciary responsibility to my company and to my employees to pay the least amount of tax I possibly can, that I legally possibly can, and every business in this country does the same. They have to. That is their job.

If you would please make the tax code easier, you know what? You would get a lot more compliance. People want the tax code to be fairer, they want it to be open, they want it to be transparent.

I frequent a site where we make these cars, and it is called Club Cobra. I have dear friends on that site. Most of them are businessmen who own these cars, and those are the guys I talk to every day. And I posted, "Hey, I am going to go give some testimony before the Senate committee on tax complexity. What do you guys think? What should I say?"

You know, not one of those men posted, "I want to evade taxes." Not one. Every one of them said, "David, tell them that we want these taxes simpler. Tell them that we want to comply, but I do not want to sit here and wonder how I am going to pay my taxes. I do not want to have to find attorneys making mountains of worthless paperwork."

That is what we are talking about. You guys wonder why we have unemployment. I will tell you why we have unemployment. Because we cannot figure out how to pay our taxes. We cannot figure out what we are going to do, how we are going to hire, and we are scared.

Obamacare comes along, all these other issues come along—Senator Hatch mentioned many things in his statement. I absolutely agree with them. And the business owners say money is a coward, it runs and hides. It gets scared. That is what happens. When the businessmen run and they hide, you know what? They put their money into bank accounts and they do not take it and they do not hire people.

I traveled to Greece—I will never forget this. I traveled to Greece last year to a guy who wanted to make a new car, and he was like, "You know, David, you make really cool cars, you can make my car, too." And so I packed up, I went to Athens, and when I went there, of course, I got to see all the riots. And I will never forget walking into this guy's basement.

That is where he had all his employees. It was 600,000 Euros for this guy to get a business license. He said, "You know what? I am not going to do it. I'm going to send the jobs to Provo, UT."

That is called capital flight, and we are seeing it in our own country.

If there is anything I could say today, it is let us be free. Really, what do you want me doing? Do you want me making cars? Do you want me creating jobs, or do you want me here in Washington, DC protesting your jobs? Because that is what I have been doing with FreedomWorks for the past 4 days.

And you know what? I would rather not do that. I would rather not hold tea parties. I would rather not be yelling. I would rather be making cars, because that is what I want to do.

Thank you.

[The prepared statement of Mr. Kirkham appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Kirkham.

Ms. Carpenter, you are last.

**STATEMENT OF KRIS CARPENTER, FOUNDER AND CEO, SANCTUARY SPA AND SALON, BILLINGS, MT**

Ms. CARPENTER. Chairman Baucus, Ranking Member Hatch, and members of the committee, I am a salon owner from Billings, MT, and I want to thank you for the opportunity to testify before you about what I have experienced in my industry regarding tax compliance.

I have been in business for 13 years and employ 40 women; 22 of them are salon and spa service providers who accept tip income.

In addition to running my salon and two other retail businesses, I am a member of the Professional Beauty Association. PBA has over 8,000 members, representing salon and spa owners, manufacturers and distributors, and individual licensed cosmetologists.

The salon industry is an industry of small businesses. It is a vibrant part of the U.S. economy, with more than 900,000 establishments and reported annual sales of nearly $40 billion. More than 1.1 million professionals work in personal appearance occupations, and one out of three do so as self-employed workers rather than employees, a fact that is central to the salon and spa problem of tax complexity and compliance.

Senator Snowe's introduction of Senate bill 947, the Small Business Tax Equalization Compliance Act, is promising news. The legislation originally came about because salon owners like me contacted Congress about the widespread problems associated with tip reporting.

It extends existing law to permit salon employers to claim the 45(b) tip tax credit that is currently available only to restaurants. The bill also provided assistance to the Federal Government by improving tip reporting in all sectors of the salon industry.

Salon owners must collect and report tip information from their employees to the IRS and pay FICA taxes on the reported tips. However, unlike the restaurant industry, salons are not eligible to claim the tax credit for FICA taxes paid on those tips.

Unlike most tipped industries, a large segment of the salon industry is classified as self-employed. While two salons may look the

same, one classifies the people behind the chairs as employees, while the other classifies its workers as self-employed or independent contractors.

The bottom line is that currently the tip reporting burden is greatest on small business owners like myself. Self-employment is significant and growing. In 2010, the average hourly wage of my service providers was $14.31, and the average reported tip income was $6.33 an hour. I pay my employees a fair wage, pay 65 percent of my employees' health insurance premiums, provide them with a 401(k) and profit-sharing opportunities.

Ten years ago, we began recording the tips received by our employees in our point-of-sale software. The amount recorded and reported was astounding to me. Prior to this accounting, I estimate that only 25 percent of the actual tip income was reported by our employees to Sanctuary.

Over this 10-year period, we will have reported $1.7 million in tip income from our employees. And remember, I am a salon in Billings, MT, and our average service ticket is $46.

Last year, we reported tip income of over $225,000, and that equaled 15 percent of our service sales. The cost to Sanctuary to match the FICA taxes on the employees' tip income was over $16,000. This places a significant burden on my business's ability to stay profitable while continuing to provide good benefits for our employees, and this kind of comprehensive accounting reporting is not a common practice in my industry.

Over the past 10 years, I have lost several employees to a lure of renting a chair. The ease of not fully reporting income or tip income, along with the common misconception by individuals in my industry that tips are gifts, not income, puts my business at a competitive disadvantage for hiring and retaining employees.

I believe it is unfair that individuals in our industry are able to take an extra $5-plus an hour in unreported income. Teachers, soldiers, bankers, grocery clerks, and other workers in this country are not allowed that choice with their income.

When you do the right thing, it should not put you at a disadvantage to those who do not.

I would like to see the gap and this unlawful practice narrowed. Two suggestions that I would like to put forth are, one, the Congress should pass Senate bill 974. The salon owners who are reluctant to comply because of the cost of the FICA match will be relieved of that burden, and the Treasury will increase its collections of taxes owed.

Number two, the IRS needs to systemize contacts with the self-employed. Their contact with the employers and industry has increased compliance. There is not an equal level of contact with the self-employed.

Thank you for the opportunity to share these ideas. I appreciate your support for my industry and look forward to working together towards a long-term solution.

Thank you.

The CHAIRMAN. Thank you, Ms. Carpenter.

[The prepared statement of Ms. Carpenter appears in the appendix.]

The CHAIRMAN. I would like to go back to Mr. Kirkham. Everybody wants the code to be simpler. Where would you simplify, what examples?

Mr. KIRKHAM. I would eliminate all loopholes that you can find.

The CHAIRMAN. And which would those be?

Mr. KIRKHAM. I am not a tax expert, nor do I profess to be. I pay somebody else to do that. But we all know of tax loopholes, because GE did not pay any taxes last year.

You have to eliminate loopholes, lower the rates, make it open, transparent, and fair.

The CHAIRMAN. I guess there are a lot of questions along that line, like some people think some provisions are loopholes, some do not think they are loopholes.

Let us take the mortgage interest deduction. Some would suggest that is a loophole and some would say, no, no, that is not a loophole because a lot of people want to own houses.

Do you have any thoughts on that one?

Mr. KIRKHAM. I would eliminate all loopholes that you can, including the mortgage interest deduction. I would make it fair for everyone.

Who are you really hurting? Who are the people who get that?

The CHAIRMAN. I am just trying to get a sense of your proposal. So eliminate all loopholes. I assume you are saying essentially eliminate all——

Mr. KIRKHAM. I would move to a—I am sorry.

The CHAIRMAN. Flat tax?

Mr. KIRKHAM. I do not know. I do not know the ins and outs. Again, I am no expert. I would look into a flat tax. I would look into a fair tax. I would look into any of those proposals——

The CHAIRMAN. And what if—what if——

Mr. KIRKHAM [continuing]. That can make it easier.

The CHAIRMAN. Right. Right. Now, what if the results—anything that is enacted here generally results in some winners and some losers. That is, some people end up paying more and some people end up paying less.

Let us assume that we had a flat tax. Under a flat tax, let us assume, for the sake of discussion, the same amount of revenue that is earned today. One could say it should be higher or lower, but let us say, just for the sake of discussion, it is about the same as revenue earned today.

Under a flat tax, some people would pay more in taxes than they pay today, and some people would be paying less than they pay today. And the people who would be paying more under a flat tax would be average Americans. The average American would be paying quite a bit more than he or she pays today. And, under a flat tax, the person paying quite a bit less than he or she pays today would be the most wealthy.

My question is, does that result comport with kind of your thinking? It is simple, but would that be fair?

Mr. KIRKHAM. I think fair is fair. I think if everybody is paying the same rate, everybody is fair. I am not saying that the very lower income levels should not have some sort of relief of some sort. No one that I know thinks that. Everybody wants to help those who are in poverty.

You refer to the people at the top. I read in the news today there was a big complaint in the *New York Times*, where they said many people with capital gains and all sorts of things are able to use loopholes to defer income, or they take a loss last year, and they are not paying tax this year.

So I think it is so complex, I do not think you know; I do not think I know. That is no disrespect. I do not think any of us knows what is going on with this tax code. It needs to be fair. Everybody needs a piece of the game.

The CHAIRMAN. I have to get on with the other witnesses here. But clearly, fairness is in the eyes of the beholder. What some people think is fair, some other people think may be not so fair. Again, some people think very low-income people should get a significant break.

Some people think——

Mr. KIRKHAM. I am not opposed.

The CHAIRMAN [continuing]. The upper, very, very wealthy should not get the same break as the very low-income break. Some people would think that.

Mr. KIRKHAM. I think you would be surprised. If you were to have—if the people in the top end of the bracket—what do they do with their money? They do not look at it. They invest it. That is how people like me start businesses.

The CHAIRMAN. So what are you saying? I do not understand.

Mr. KIRKHAM. It should be fair for everyone. I am not opposed to any sort of a break for people who are in poverty, by any stretch. I was a missionary in Peru, and I have walked among the desperately poor. They have a very dear place in my heart. I will not abandon them.

However, once we get past some level of poverty that we can all agree on, open, fair, 10 percent, 20, whatever that is, it needs to be fair beyond that.

I think you would be surprised at how much revenue would actually come in.

The CHAIRMAN. Let me ask just a basic question. My time has about expired. All three of you—it will have to be very brief answers.

Is most of the so-called tax gap, in your judgment, intentional, or is most of it just mistakes, unintentional mistakes?

Mr. Brostek?

Mr. BROSTEK. Well, as I said in my oral statement, I am really not aware of any reliable estimate on that. It is trying to get into someone's head and decide, why did they make an error, and that is a very difficult thing to do.

The CHAIRMAN. Your best guess.

Mr. BROSTEK. I think it varies all over the place. What we know is that, when the transactions that affect income are not transparent to IRS, compliance is much lower. So where there is an opportunity to be noncompliant, there is much more noncompliance.

The CHAIRMAN. Ms. Olson, why don't you try?

Ms. OLSON. Well, the largest portion of the tax gap is underreporting income. So it is either people not reporting the income that they made, or that they are taking deductions that they

should not be taking. And on the deduction side, I would say that is where you might have complexity.

On the underreporting of your gross income, I think you might see the effect of people feeling—that is the tax morale issue, that people feel that somebody else is getting away with something, so I am going to create a tax break of my own. The income is not reported to the IRS. The IRS does not know it. So what they do not know, they will never find out unless they come and find me.

The CHAIRMAN. Mr. Kirkham, I will ask you the same question. You seemed a little irritated.

Mr. KIRKHAM. No, I was not irritated. I was absolutely agreeing.

The CHAIRMAN. No, no. You seem to have strongly held views that the code is not fair.

Mr. KIRKHAM. It cannot be if it is 70,000 pages long.

The CHAIRMAN. So my question is, do people in your business or businesses, because they feel that the code is not fair, tend to underreport?

Mr. KIRKHAM. I was not referring to my businesses. I was referring to many things that I have heard other people say.

The CHAIRMAN. By other people, do you think——

Mr. KIRKHAM. Just other people. It is only human nature.

The CHAIRMAN. No, I am asking—if I can ask this very simple question. Do you think that the people you talk to who think the code is unfair, do you think they, therefore, because they think it is unfair, tend to underreport?

Mr. KIRKHAM. I think that is undeniable. They feel it is too complex. They feel like other people are getting away with it. Let us face it. When GE is not paying taxes, which is their, again, fiduciary responsibility to minimize those as much as they can, it is their duty to their shareholders, what does the average little guy think?

The CHAIRMAN. Ms. Carpenter, my time is up, but what do you think most people—is the tax gap just due to innocent mistakes, or is it due to "I am going to over-expense this item" or "I am just not going to report"?

Ms. CARPENTER. I do not think a lot of it is mistakes. I think a lot of it is the ease of not reporting, especially in my industry. It is easy. Anything that is cash disappears.

The CHAIRMAN. Thanks very much.

Senator Hatch?

Senator HATCH. Well, I want you to know, Mr. Kirkham, I agree with you.

Mr. KIRKHAM. Thank you.

Senator HATCH. The code is so doggone complex that nobody understands it. I would venture to say there is hardly a person on this committee who does not hire tax attorneys or accountants to prepare their income tax returns, because it is just so complex that it is very difficult for us to do it, and yet we are the tax-writing committee.

So your points here are very well-made, very well-taken. And I think the points of everybody here have been—I do not mean to single you out, except I actually believe that you have spoken a lot of wisdom and a lot of practical wisdom here today.

Everybody hates the tax code, and there is good reason for it. And I think it is incumbent upon this committee to come up with a simplified version of the tax code that will cause people to comply. And I agree with you. We would have a lot more revenues come in to this government if people did not think they were being ripped off by the government, and, if 51 percent of them who do not pay income taxes now would pay, 51 percent of households, that is, would pay income taxes, or at least those who are not in poverty would pay income taxes.

Ms. Olson, you appropriately point out in your testimony that tax simplification is a requirement of greater tax compliance, the same thing that Mr. Kirkham is saying here, and Ms. Carpenter as well. And we ought to listen to you guys.

Not to get too philosophical, but are there not other reasons for simplification as well? Most citizens who are not lawyers have little interaction with the United States Code, and the exception is with the Internal Revenue Code, which also happens to be the part of the code that most regularly impacts the individual rights to liberty and property.

Beyond compliance, is it not also just that, in a democracy committed to individual rights, people should be able to understand the law that they are forced to comply with? And assuming the answer is yes, and I hope it is, I encourage all our witnesses to elaborate, if you will.

But we will go to you, first, and then to you, Mr. Brostek, you, Mr. Kirkham, and you, Ms. Carpenter.

Ms. OLSON. I think, as you point out, that United States taxpayers' interaction with their government, it is through the tax code; that perhaps in retirement, you have interaction with Social Security, but even in retirement, you have interaction with the IRS as well.

And the IRS is the face of the tax code, and as taxpayers experience arbitrary, capricious, confusing, unexplained results and look around and see different results for them from similarly situated others, or they go to cocktail parties and they hear about how one person is doing something that they did not think to do——

Senator HATCH. You seem to be saying pretty much the same thing Mr. Kirkham has.

Ms. OLSON [continuing]. These all undermine confidence and erode the social contract, where we, as the government, are asking taxpayers to voluntarily come forward and tell us their most personal information, their financial information, and, in return, we are going to treat them well. And complexity makes it hard for the IRS to treat all taxpayers well, because it is just so complex for them even.

Senator HATCH. Mr. Brostek?

Mr. BROSTEK. Well, part of your question was whether there are other effects of complexity besides on compliance, and there are. There are economic efficiency effects for the country.

Many of the tax expenditures, tax benefits, are intended to encourage some kind of activity, to correct market failure. But, if those interventions are not working well, we can actually be causing more harm to the economy than we are benefitting the economy.

Senator HATCH. I would be interested in you sending us a letter telling us which ones you think work well and which ones do not work well.

Mr. BROSTEK. I am afraid I do not have the full inventory, but I can make sure that you get the products that we have put out on this.

Senator HATCH. That would be great.

Mr. Kirkham?

Mr. KIRKHAM. I would just add that the earned income tax credit is welfare, and that is okay, but it ought to be in the welfare department. It should not be in the tax department.

Your tax code should—again, this is complexity. Your tax code should be your tax code. Your social services code should be your social code. And in that, we should vote. It should be up for vote. Hey, we want to put this much money into social services, great. We want to put this into the tax code, great.

But from a business standpoint, when we have all these things that we are doing and all these withholdings, it becomes—it is an avalanche, it is a tsunami that buries us, which makes it so that we have to hire a lot of people to help us out.

Senator HATCH. Thank you.

Ms. Carpenter?

Ms. CARPENTER. Well, I just find that the complexity is challenging for me as a business owner. I spend a lot of time trying to figure out how to do the right thing rather than growing great businesses and providing jobs, and it just—it has taken more than I would have ever imagined to learn what I had to learn to comply, and it is complicated.

Senator HATCH. Let me just say to all of you—my time is up, but let me just say to all of you that I think this has been a very interesting panel, and I think we on this committee have an obligation to somehow or other do our best to simplify this tax code so that everybody is treated fairly, and that is a big assignment, a big job.

And it is not just hammering one part of the economic spectrum because they are wealthy, and it is not just letting 51 percent of households off from paying income taxes. It seems to me there has to be some way of everybody having an appropriate amount of skin in this game, if you want to call it that. And I think you all make some pretty good points here. I am paying attention, and I hope everybody else is.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. I think you are right. Since 1986, I think you yourself pointed out that there were close to 14,000 changes to the tax code, just layer upon layer upon layer.

Senator HATCH. And part of that is this committee.

The CHAIRMAN. Well, it is the Congress.

Senator HATCH. Well, it is Congress as a whole, but this committee should stop it, and that is what they are saying to us.

The CHAIRMAN. And that is the reason why we are holding the tax reform hearings. It is both individual income tax and corporate income tax reform here. The code has to be reformed, and the sooner the better. In fact, I think we are at a stage in American history where we may have some fairly radical changes over the next cou-

ple of years to the code, due basically to the kinds of problems that we are hearing today—legitimate problems, legitimate concerns.

Senator HATCH. Well, I would like to get it to where we do not play politics with it, and we do what is in the best interest of everybody and do what is fair and simple and workable. And, if we can arrive at that, my gosh, you and I could—we could go home and feel pretty good about it.

The CHAIRMAN. Yes, we could.

Senator Bingaman?

Senator BINGAMAN. Thank you, Mr. Chairman. Thank you all for being here.

There is a good article in the *New York Times* this morning by Bruce Bartlett, who used to be on the staffs of Jack Kemp and Ron Paul and worked in the Reagan and Bush administrations—the George H.W. Bush administration.

Anyway, he says—I think everybody would agree with this—he says there are 78,000 tax filers with incomes of $211,000 to $533,000 who will pay no Federal income taxes this year. Even more amazingly, there are 24,000 households with incomes of $533,000 to $2.2 million with zero income tax liability, and 3,000 tax filers with incomes above $2.2 million with the same Federal income tax liability as most of those with incomes barely above the poverty level.

And then he says, perhaps the right and the left can at least agree that it is unseemly for those in the top 1 percent of income distribution, with incomes at least 10 times the median income, to pay no Federal income taxes.

So I assume everybody agrees with that. I just thought it was an interesting point to be hearing from Mr. Bartlett at this point.

Let me ask you, Ms. Olson, about your point. You said that 5 percent of the tax gap is the result of overpayments of the earned income tax credit, as I understand it, or people claiming——

Ms. OLSON. Over-claims, yes.

Senator BINGAMAN. Over-claims; people claiming that when they should not.

Most of the rest, as I understood what you said, most of the rest of the tax gap is the result of underreporting of income, either people who just basically do not report enough of their gross income, they leave things out, or people who take deductions that they should not take.

Between those two, which of the two is the biggest problem, as you see it: people failing or refusing or purposely not reporting their gross income properly, or people taking deductions they should not take?

Ms. OLSON. Well, the IRS's 2001 figures—and so we only know this from 2001; they are not updated yet—but 55 percent of the individual tax gap is attributable to unreported business income. And so it is $197 billion.

Senator BINGAMAN. And is there a proposed fix for that that you are urging us to adopt?

Ms. OLSON. Well, I think it is a combination of things that can be fixed. Certainly, some of the provisions that Congress has already passed about the reporting of credit card payments, gross income reported in that way, will help.

I think some of the proposals that Ms. Carpenter is talking about, where you are equalizing between those who are paying people as employees and those who are doing things as self-employed, will help.

I think there are other ways of looking at it where you—there is always going to be some underreporting. I also have to say I think that education and doing well-placed enforcement approaches has an indirect effect on everyone.

So, if the IRS goes out and does some well-placed audits in industries where we know there is massive underreporting, then you get a ripple effect, where people will be compliant for a period. And you do not have to do very many audits; they just have to be the right ones. So that word of mouth works.

Senator BINGAMAN. You also said that there is a significant problem with people taking deductions they should not take.

Are there a few, two or three or four deductions that are the worst offenders in that area that we could target in on, and either eliminate those deductions for everybody or find some way to see that they are only taken by those who are entitled to them?

Ms. OLSON. Well, I think, surprisingly, a lot of the itemized deductions, things like charitable contributions, where people do a lot of fudging, I think, that is a real policy call for Congress whether they want to eliminate that or not.

Then again, the independent contractor-employee issue is a big one. Home office deduction, there is a lot of noncompliance in it, because it is confusing, and we have proposed a standard deduction for the home office, in a way, to give people some certainty; if you claim that, you know you will get it, you will get it right, you will get it correct, rather than fudging with it or not knowing whether you have gotten the right amount.

I think there are some real opportunities there.

Senator BINGAMAN. I think my time is up, Mr. Chairman.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman.

Let me start with you, Ms. Olson, and ask about the alternative minimum tax. My sense is to the middle-class taxpayer, this is just bureaucratic water torture. If you are a middle-class person, you are, in effect, filling out your taxes twice under separate systems.

Do you think that if you repealed the alternative minimum tax, that that would go a significant way toward simplifying the system for the individual?

I am not saying it is going to, obviously, take care of all simplification issues, but do you believe that repealing the alternative minimum tax would go a significant way towards simplifying the tax system?

Ms. OLSON. Absolutely. We have recommended that for years. We did a calculation, taking the Brady Bunch as an example, and determined that they would be better off living—cohabiting rather than getting married because of the impact of the alternative minimum tax on their combined household as a married couple.

Senator WYDEN. One other question for you on this simplicity issue in terms of steps that could be taken quickly. Do you believe that if you were to go to a purely voluntary approach, purely voluntary, and say that taxpayers could have the option to have the

IRS calculate what the taxpayer owes and then send the taxpayer a pre-filled-out form, and the taxpayer either could submit it or they could correct it or revise it, that that, too, would go a significant way towards simplifying the system?

Ms. OLSON. I think for a class of taxpayers, that is possible and would be very helpful. I think going to what Chairman Baucus said earlier, the IRS needs to get this information early in order to do it. We cannot do it now.

It will also have huge compliance effects for those people who get refunds because they underreport income and later we have to catch them and try to pull it back. So it really will benefit lots of people if we can do that.

Senator WYDEN. One of the reasons that I have been supportive of this approach is it tracks very much with your concept of a voluntary focus to improving compliance.

Really, when you look at your testimony, you go to this question of a voluntary approach continually, and that is the way I would envision this. Nobody would ever be required to do it. But if someone voluntarily wanted to do it, they could.

Now, one taxpayer group has said that this kind of approach creates a conflict of interest. Now, I find that a little bit odd to conclude if you are talking about something that is purely voluntary.

As the independent advocate for taxpayers, do you see this type of voluntary system giving taxpayers—when you give taxpayers the option to use it or not, would you say that is a conflict of interest?

Ms. OLSON. I have never understood that statement. It is based on the thought that we would be able to see—when people electronically file or something, we would be able to see erasures or over-typing. And as someone who has seen penciled-in returns that people submit, you can see erasures on existing returns today. I mean, we do get the data. So I do not see the conflict.

Senator WYDEN. One question for you, Mr. Brostek. I was interested in your idea that the code should have, on an ongoing basis, a periodic review. It seems to me that, especially when we get a tax reform bill, a major tax reform effort that simplifies the code, reduces a lot of the narrow breaks to hold down rates and keep progressivity, unless you have something like what you are talking about, it will almost be natural that people will keep coming back to add again and again and again.

And your idea of a periodic review—I think both you and Ms. Olson have talked about this in the past. Maybe I can bring both of you into this discussion. How would you do such a thing, and what would be the benefits?

Mr. BROSTEK. Well, I am not sure what would be the very best way, but what you want, if you are doing a review, is to know whether the provisions that you have are effective.

So you want someone to be gathering the information and doing the analysis so they can come back to you and give you some data to make a decision about whether a provision that has been adopted is worth having.

So there could be some kind of a schedule for doing that over time. You might start with the largest ones first, but that would be the basic thing that you would want.

Senator WYDEN. My time has expired. And I noted that in your testimony as well, Ms. Olson, and I think that is a constructive idea.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. Thank you, Senator.

Senator Carper?

Senator CARPER. Thank you, Mr. Chairman. And to our witnesses, welcome. Thank you all for being here today. And I especially want to thank Mr. Brostek and the folks at GAO and Ms. Olson for your input and availability, as my staff and I have worked on tax gap legislation again this year as we have in the last Congress.

One of the things I like to do whenever we are discussing changes in the tax code or tax reform, I like to ask basically four questions.

The first of those is, is it fair? Second of those is, how does it promote economic growth and predictability and certainty? Number three is, how does it affect budget deficits? And number four, does it simplify the tax code or make it even more complex?

I think those are four pretty good guidelines. You look through those questions almost like a prism as you evaluate the different proposals that are before us.

Our country is facing, as we know, staggering budget deficits this year and in years to come, and it is imperative that we put our country back on the right fiscally responsible track.

As this hearing highlights, one way to help get our deficits under control is to address the tax gap. I think it offends most of us—and we have heard some of this this morning—it offends most of us who think we are paying our fair share of taxes to know there are a lot of people who are not doing that, and I am told that the tax gap, the last time it was calculated, was close to $300 billion in 2001, probably larger today.

Ms. Olson, you have estimated that each taxpayer is subsidizing—I think you said subsidizing noncompliance, which basically means we are paying $2,000 or more apiece to make up for folks who are not paying their fair share, in some cases by accident, and in some cases, it is purposeful.

And that is why I am introducing legislation today that is called the Tax Gap Act of 2011, which would reduce opportunities for noncompliance, simplify filing requirements, would crack down on lawbreakers, and ultimately reduce compliance burdens on law-abiding taxpayers.

This bill incorporates a number of ideas that have been proposed by former President Bush and his administration and by the Obama administration, as well as a number of other just common-sense initiatives.

I believe that enacting this legislation will be an important step forward in reducing deficits and hopefully in making our tax system fairer.

With that said, however, Ms. Olson and Mr. Brostek, I ask you, what else can we be doing? And in your testimony, as you highlighted here, there is noncompliance, and you made suggestions for ways to reduce both deliberate and accidental noncompliance.

I would like to ask each of you just to take a minute or two and tell us on the committee which one or two ideas among the ones that you have highlighted here would present the best opportunities for reducing the tax gap.

Mr. Brostek, why don't you go first? And then Ms. Olson.

Mr. BROSTEK. Well, there are so many opportunities, it is hard to say what is really the best way. The overall best way is always to try to get information reporting on income or deductions. But the low-hanging fruit has been picked there. So it is more difficult now to figure out how to get that kind of transparency over income or deductions.

But one of the things that we can do is make better use of the information returns that we currently get. So, for instance, we have had some work where we looked at the mortgage interest deduction and compliance with that. And some simple things, like recording the property address on the 1098 that comes in or recording whether there was a refinancing in that year or what the total mortgage amount is could help IRS in policing the various requirements for that.

For students, the institutions, the educational institutions send IRS——

Senator CARPER. By the way, I believe my staff just told me our bill that I just mentioned actually does that. So thank you.

Mr. BROSTEK. For educational institutions, they send taxpayers a 1098–T, but they can report either the amount that they billed or the amount that someone paid.

All that information is not useful to IRS unless it is really the amount paid, because that is the amount that is deductible. So we could revise that form to require the information that is actually actionable by IRS.

Senator CARPER. All right. Thank you.

Ms. Olson?

Ms. OLSON. Well, in my testimony, I list several recommendations, including education and retirement provisions. But in my last year's annual report, one thing that I recommended was that, as Congress decides whether to implement a policy through the Internal Revenue Code, it should go through an analysis, beyond just the public policy, that it is a good public policy to support this provision, but is it something that we can do well through the code.

And there may be times where we conclude that doing it through the tax system makes sense. It puts the least burden on the beneficiary, and it is something the IRS can manage.

And to Mr. Brostek's point, we get the data that we can give Congress to evaluate whether this provision is actually fulfilling its public policy objective. Right now, we have so many provisions in the code, and we have no data.

The IRS itself cannot gather it because it is really economic information external to the IRS, and there is no mechanism for coming back in and saying, "Okay, we have put this provision in. Does it make sense?" If it does not, then we can get rid of some complexity by moving it out, and I think that kind of discipline is vital, both as part of tax reform, and on an ongoing basis.

Senator CARPER. Thanks for those responses. And, since my time has expired, I just want to thank all of you for being here and shar-

ing your ideas with us today, and, especially to Ms. Olson and Mr. Brostek, a big, big "thank you" for all your help.

Mr. BROSTEK. You are welcome.

The CHAIRMAN. Thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman. I want to thank our panelists for their suggestions, and hopefully this will be part of a debate about tax reform that will end up in us actually doing something about tax reform, because it is long overdue in the country.

I want to ask a question. According to the GAO, of the $345 billion in the gross tax gap in 2001, the IRS ultimately recovered about $55 billion, or about 16 percent of the total.

If we can estimate the amount of the tax gap, and we know the major areas where tax compliance is weakest, how do you explain the low recovery rate by the IRS?

Mr. Brostek?

Mr. BROSTEK. There can be many, many reasons for that. In some cases, it is simply the taxpayers owe, but they do not have the resources to pay. So there is certainly a significant amount of that.

An awful lot of the compliance problems in the tax gap are in relatively small dollar amounts, and so it does not pay IRS to invest a lot to go after them. Those small dollar amounts can add up to significant amounts of money, but trying to figure out the cost-effective way of going after that noncompliance is very difficult.

Senator THUNE. If you look at the enforcement efforts by the IRS, only about 3 percent of the tax collection is a result of these efforts, while 97 percent, as I think has already been noted, is a result of voluntary tax compliance by taxpayers.

Yet, we tend to focus, here in Congress, our discussions on enforcement. But considering that statistic, are there steps that the IRS could take in terms of customer service to improve the voluntary compliance component of this?

Ms. Olson?

Ms. OLSON. The IRS, in its strategic plan for 2009 to 2013, set a goal of increasing the tax compliance rate by a little more than 2 percent. And based on how it is doing it by enforcement, to raise that kind of revenue and that compliance increase, it would have to increase enforcement revenue by 144-percent to get that increase.

So it is clear to me that Congress is not going to fund us to get a 144-percent enforcement increase.

The name of the game is taxpayer education, service, outreach, really working with groups and strategically using our enforcement resources for the right pressure point and getting indirect benefits.

And I think then the complexity, where you get to taxpayer morale, that so much of, I believe, noncompliance is sort of what I call self-help. Taxpayers believe that somebody else is getting a benefit, and so they help themselves to some other benefit themselves. And if we can change that dynamic, we will get greater compliance.

Senator THUNE. We have over 6 billion hours complying with the tax code every year, and I have seen the breakdown here of kind of what that translates into in terms of cost for the individual taxpayer, if you are a non-business individual taxpayer.

But what is the estimated cost to our economy of over 6 billion man hours being spent filling out tax returns that could otherwise be put to hiring more people or purchasing new pieces of equipment, something that would actually add to our country's economic growth?

Mr. BROSTEK. We did a study in 2005 surveying the literature. The best estimates that we found at the lower end were about $107 billion per year of costs for complying with the tax code. That was both for individuals and corporations.

Senator THUNE. And that is the low end.

Mr. BROSTEK. That was the low end, yes.

Senator THUNE. Well, that is a conservative estimate. It certainly suggests that there could be a lot of additional——

Mr. BROSTEK. Senator, can I come back to your earlier question for just a moment?

Senator THUNE. Yes.

Mr. BROSTEK. While I agree with everything that Ms. Olson said about providing better service, one of the important facts to understand about the tax system now is that only about 10 percent of taxpayers sit down with paper and pencil and do their returns. Sixty percent go to a paid preparer.

Another 30 percent or so buy tax software to deal with the tax obligations that they have. That makes an important chokepoint here, the paid preparer community, making sure that they are well-educated and competent for their responsibilities, that they are very ethical in carrying out their responsibilities, and that the software packages that both the paid preparers and the taxpayers use are reflecting the tax code well in order to get good, high levels of compliance.

Senator THUNE. If I could, very quickly, for Mr. Kirkham or Ms. Carpenter. I am interested in knowing, just in terms of the tax certainty—we all talk about economic certainty and knowing, having predictability in policy coming out of Washington so that you can plan at least around it.

Can you discuss that aspect and how important it is in shaping your business decisions? And I guess what I am getting at is, is there a major difference between a provision of the tax code that lasts for a number of years, and elements of our tax code that expire or get changed on a year-to-year basis, because we have a good number of those that consistently are up for renewal, it seems like every year?

Explain how tax certainty bears on your decision-making.

Ms. CARPENTER. It is extremely difficult, because every year, it is a different game, and you never know if you really have everything in front of you. And like Mr. Kirkham said, you have to hire other people at extra expense to your business always, because it is beyond the comprehension of most small business owners like me.

It is more than we have the resources or time to get through. So you do the best you can.

Senator THUNE. Anything to add to that, Mr. Kirkham?

Mr. KIRKHAM. I would just say that what is happening right now in the tax code is the tax code is driving our business decisions. Our business is not driving our business decisions.

So, at the end of the year, when we have a capital improvement and you guys give us a $200,000 write-off so we can buy a new piece of big equipment—a big CNC, computer numerator control—you know what? What if I wanted that money for something else? I cannot.

Well, I am going to go buy a new piece of equipment instead, because, if I keep it, what happens? If I keep the money, I should say, I am going to get taxed on it. Well, I am going to go put it in a piece of equipment that I can write off.

Maybe or probably or definitely, I could have used that money in a much better way that would have created more jobs. And I cannot say it enough, this whole discussion is about jobs.

Senator THUNE. Thank you. Thank you, Mr. Chairman. Thank you all very much.

The CHAIRMAN. Thank you, Senator.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. And I want to thank all of our witnesses here today. Some of us recall the day when we had the 1986 tax reform that was supposed to be a simplification. So much for that idea. And here we are today, regrettably. And I understand your frustrations, Mr. Kirkham. I hear that all the time as ranking member of the Small Business Committee. I agree with you.

This has certainly had a profound impact even on job creation and economic growth in this country because of the undue burden that the tax code has placed on small businesses and the ability just even to try to conform with the tax code.

Ms. Carpenter, I appreciate you mentioning the legislation I have introduced along with the chair of the Small Business Committee, Senator Landrieu. I do think it is important to put you on par with the restaurant industry, and a point that you made and underscored is the fact that, unlike that industry, your employees can move to another employer and just rent chairs as a way of circumventing all of that.

And so it does have a tremendous impact on your business, and hopefully we can get this done, because I think it is a matter of fairness.

Ms. Olson, we really need comprehensive tax reform—and, I mean, I have argued for that for some time—in order to achieve simplification. But are there efforts that we can do now to help improve the situation for small business owners? For example, Ms. Carpenter talked about making it fair in terms of the tip credit and making the salon industry eligible for that.

The 3-percent withholding on government contractors is another issue that Senator Brown has introduced, and I have joined him as a co-sponsor. That makes these contractors have to pay their liability up front. That is resulting in job losses, business loss, not to mention the fact of a loss of revenue. It is going to cost more to comply with that than the money that is intended to be raised by this provision that was enacted in 2005.

So could you tell us what you think would be important in passing some initiatives that could make a difference for small business at this point in time?

Ms. OLSON. Well, there are two that go specifically—one, to the 3 percent. One thing that we have advocated for a long time was that, instead of doing a withholding requirement on Federal contractors, you just make it a requirement that, before the contract is awarded, there be a review—is that entity in compliance with the Federal tax laws?

And part of that can be, well, if you are not in compliance, what do we need to do to get you into compliance? It is a proactive approach. We do that in the Internal Revenue Service.

For example, when I give grants to low-income taxpayer clinics, I do a compliance review and do not award that money if they are not in compliance or getting into it. That gets rid of that withholding, and it also puts the leverage on getting people into compliance. It is a positive thing.

Another thing that we actually worked with the salon associations about was a recommendation that the law be changed so that, if you were going to categorize workers as independent contractors, then you could voluntarily do withholding on those workers.

So, if someone rented a salon sink, a desk, then the salon owner would do some withholding on that person. And so, even if you did not categorize them as employees, you still got more of a level playing field there. And so we have worked on that legislation.

Senator SNOWE. Well, it is interesting, because, obviously, this is a central piece and becomes even more profound because of where we are economically in creating jobs, and that is having a huge impact on small business.

As you say, 94 percent of the noncompliance is with small businesses. It is unintentional, for the most part.

So the question is, what we can accomplish in the interim if we cannot get comprehensive tax reform—which I think we could, frankly, if we put our minds to it and work on it now as opposed to years down the road when it makes a huge difference in terms of the economic environment.

Now, the health care law is a good example. We passed a small business tax credit that was scheduled to go into effect in 2010. An accountant in Maine, it took him 9 hours just to determine whether or not he was qualified for this tax credit.

Now, that was an accountant for himself determining whether or not he was qualified. I mean, here is another example of absurd complexity when it comes to the tax code. It is unnecessary.

But, frankly, it is our responsibility to make sure, when these types of initiatives are passing Congress, we should be responsible in terms of how to implement them and how they take effect.

Are you aware of that complex tax credit?

Ms. OLSON. Yes. And my office actually has been developing a calculator. Actually, one of my employees in the Montana local taxpayer office did it in his spare time. But we have adopted it, and we are trying to test it right now so we can get the IRS to put it up on the website.

So, if you just plug in certain numbers, the algorithms will do the rest of the calculation. But it is very complicated, and it may be, as Mr. Brostek pointed out, that software might get a different answer from what we get, because the calculations are so complicated.

Senator SNOWE. Do you think that we could achieve even a modicum of simplification if we were to at least identify those issues that could make a difference for small businesses and individuals?

Another initiative that I have joined with Senator Enzi on is conforming the tax information on subchapter S and C corps, verifying that information at the same compliance date.

Ms. OLSON. I think there are a lot of things, a lot of individual proposals, where you do not have to have comprehensive tax reform. The only point I would make about comprehensive tax reform is, then you are looking at the whole picture so you do not create some gaps that then lead to more provisions later on to close those gaps.

Senator SNOWE. Yes. I do not disagree with you. I am just wondering if, in the meantime, there are certain things that we can identify, and we should readily do so, because it is just affecting job creation. I think that is the bottom line here. And it would give great impetus, I think, to help those who are struggling, frankly, and I think that that is something that people do not easily recognize here in Washington, inside the Beltway, about what is detrimental to job creation.

I think Mr. Kirkham expressed that frustration very eloquently, as well as what Ms. Carpenter is experiencing in her own salon because of the inequities in the tax code.

So I appreciate your testimony here today. Thank you.

Senator HATCH [presiding]. Thank you. I want to personally thank all of you for testifying here today. I thought the testimony was very, very good and very informative and illuminating, because it is apparent that this committee has to start doing its job. I am not blaming anybody on the committee, I just want to say that we—I think that is why we are holding these hearings, and I want to commend the chairman for doing so and bringing good people like you in to testify before us.

We simply have to change this tax code, and we have to change a lot of other things in our society, as well. It is a shame that the greatest society in the history of the world is in danger of failing because we are unwilling to do our job here.

So I just want to thank each of you for taking time out of your busy schedules to be here and to testify. I do not think your time has been wasted at all.

So with that, we will recess until further notice.

[Whereupon, at 11:35 a.m., the hearing was concluded.]

# APPENDIX

## ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

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**Hearing Statement of Senator Max Baucus (D-Mont.)**
**Regarding Tax Code Complexity and the Tax Gap**
*As Prepared for Delivery*

John F. Kennedy said, "To the extent that some people are dishonest or careless in their dealings with the government, the majority is forced to carry a heavier burden."

In today's tax code, the majority is carrying a heavy burden. It's a burden of hundreds of billions of dollars in taxes that are owed but not paid. It's a burden that prevents us from building new schools or investing in cutting-edge scientific research. It's a burden that keeps us from paying off the debts we owe and reducing our deficits.

According to the latest IRS estimates, the number of tax dollars that are owed but remain unpaid is $345 billion each year. This disparity is often referred to as the "tax gap." Today, the tax gap equals nearly 20 percent of our forecasted deficit for this fiscal year. In short, the tax gap is more than $300 billion that we simply can't afford to waste.

Part of the tax gap is the result of tax cheats who simply refuse to comply with the law, which increases burdens on the rest of us. But a portion is due to taxpayer confusion and unintentional errors as well.

We can certainly all agree that the tax code is extremely complex. According to IRS data, U.S. taxpayers and businesses spend more than six billion hours each year complying with the filing requirements of the Internal Revenue Code. As the Taxpayer Advocate's 2010 annual report points out, if the hours Americans spent on tax compliance were instead spent on an industry, it would be one of the largest in the United States. Six billion hours is equal to the work of more than three million full-time employees.

Today's hearing will focus on the issues of tax complexity and the tax gap, as well as the correlation between them.

Does confusion surrounding the complexities of our tax code lead to non-compliance? Can filers simply not figure out the law and how to comply with it? Or is the tax code so confusing because we have patched up loopholes and written new rules in an effort to prevent non-compliance?

First we must ask why people fail to meet their tax obligations. Failure to comply can take three forms: underreporting the amount owed; underpaying the amount a taxpayer acknowledges is owed; and simply not filing at all.

Reports from the Government Accountability Office and the Joint Committee on Taxation have found there are two proven ways to reduce noncompliance – information reporting and withholding.

IRS research supports these findings, demonstrating that more taxes are paid with increased information reporting. When individuals and businesses provide substantial information about spending and income, the compliance rate is over 95 percent. When there is little or no information reporting, the compliance rate drops to 46 percent. However, recent experience suggests that, in some areas, requiring American taxpayers to file additional information reports or withholding taxes is simply too burdensome.

Perhaps there are other solutions. For example, we should ask ourselves: Are there ways the IRS can harness new technology to do more with the same resources?

IRS Commissioner Shulman has proposed changes that would help the agency process tax data more quickly. This upgrade would ensure the IRS has the information it needs to check the accuracy of tax returns immediately after they are submitted. The IRS could identify errors instantly and reduce audits required down the road.

We should also consider ways the tax code is so complex that it actually discourages compliance. In 1987, a year after Congress passed major tax reform legislation, the instruction book for the primary individual income tax form was 56 pages, not light reading by any stretch of the imagination. But by 2009, that figure had grown to 174 pages.

This complexity makes it hard for taxpayers who honestly want to pay their taxes to figure out what they actually owe, and as a result, they often overpay or underpay.

We must do more to understand the sources of the tax gap and compliance burdens so we can make progress uncovering new, creative solutions.

I've said before we should aim to reach a voluntary compliance rate of 90 percent by 2017. To reach that goal, we need to think strategically. How can we reform the tax system so we collect the revenue that is due to the government in the most efficient manner possible? Do we need to tear down the current system and start from scratch? Can we keep the foundation? Do we just need a fresh coat of paint?

So let us consider solutions to close the tax gap that are both creative and efficient. Let us work to reform our tax code in a way that will help us collect more of the taxes that are owed but not paid. And let us continue our work to make the tax code more fair and simple.

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United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
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# TAX GAP

# Complexity and Taxpayer Compliance

Statement of Michael Brostek
Director, Tax Issues
Strategic Issues


GAO-11-747T

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Accountability • Integrity • Reliability

# Highlights

Highlights of GAO-11-747T, testimony before the Committee on Finance, U.S. Senate

June 28, 2011

# TAX GAP

## Complexity and Taxpayer Compliance

### Why GAO Did This Study

Taxes are necessary because they fund the services provided by government. Several years ago, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $345 billion for 2001. In the face of large and growing deficits, it is important to seek out potential causes and solutions to the tax gap.

Achieving high levels of voluntary compliance is made more challenging as the tax code expands. Tax expenditures—preferential provisions in the code such as exemptions, exclusions, deductions, credits, and deferral of tax liability—have expanded the tax code, more than doubling in number since 1974.

GAO's statement focuses on four key areas: (1) how complexity adds to taxpayer burden and economic efficiency costs; (2) how complexities in reporting income contribute to the tax gap; (3) how tax expenditures add complexity and contribute to the tax gap; and (4) possible strategies for addressing the tax gap. The statement is based largely on GAO's previous work conducted on tax compliance issues affecting individual taxpayers from 2005 through 2011.

### What GAO Recommends

GAO does not make any new recommendations in this testimony.

View GAO-11-747T or key components. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

### What GAO Found

The federal tax system contains complex rules. These rules may be necessary, for example, to ensure proper measurement of income, target benefits to specific taxpayers, and address areas of noncompliance. However, these complex rules also impose a wide range of recordkeeping, planning, computational, and filing requirements upon businesses and individuals. Complying with these requirements costs taxpayers time and money. In 2005 GAO reviewed existing studies and reported that even using the lowest available compliance cost estimates for the personal and corporate income tax, combined compliance costs would total $107 billion (roughly 1 percent of gross domestic product) per year; other studies estimate costs 1.5 times as large. Economic efficiency costs, which are reductions in economic well-being caused by changes in behavior due to taxes, are estimated to be even larger.

Although many taxpayers have simple forms of income, others do not—especially those who receive income from capital gains, rents, self-employment, and other sources—and they may be required to do complicated calculations and keep detailed records. This complexity can engender errors and underpaid taxes. For example, GAO has documented millions of taxpayer errors in following complex rules for determining taxpayers' "basis"—generally the taxpayer's investment in a property—in securities they sold or corporations they own.

Tax expenditures add to tax code complexity in part because they require taxpayers to learn about, determine their eligibility for, and choose between tax expenditures that have similar purposes. Tax expenditures also complicate tax planning, as taxpayers must predict their own future circumstances as well as future tax rules to make the best choice among provisions. Taxpayer errors contribute to the tax gap. For example, in 2001 taxpayers underreported $6.3 billion in net income due to misreported Individual Retirement Arrangement (IRA) distributions. But taxpayers also may underclaim benefits to which they are entitled. According to GAO's past analysis, of tax filers who appeared to be eligible for a higher-education tax credit or tuition deduction in tax year 2005, about 19 percent, representing about 412,000 returns, failed to claim any of them.

No single approach is likely to fully and cost-effectively address the tax gap, but several strategies could improve taxpayer compliance. These strategies could require actions by Congress or IRS. For example, Congress can simplify the tax code by eliminating some tax expenditures and by making definitions more consistent across the tax code. IRS and Congress could take steps to enhance information reporting by third parties or expand compliance checking before refunds are issued.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee,

I am pleased to be here today to discuss complexity in the tax code, taxpayer burden, and steps to improve compliance. Taxes are necessary because they fund the services provided by government. Complexity, and the lack of transparency that it can create, exacerbate doubts about the current tax system's fairness. Public confidence in the nation's tax laws and tax administration is critical because we rely heavily on a system of voluntary compliance. If taxpayers do not have confidence in the tax system or do not believe that it is easy to understand and treats everyone fairly, then voluntary compliance is likely to decline.

The current tax system is widely viewed as complex, thereby reducing the ability of individuals to understand and comply with tax laws. According to a 2010 report by the National Taxpayer Advocate, the tax code has grown so long that it has become challenging even to figure out how long it is. Important sources of tax code complexity are income documentation requirements and tax expenditure rules, which I will discuss in more detail later in my statement.

Several years ago, the Internal Revenue Service (IRS) estimated that the gross tax gap—the difference between taxes owed and taxes paid on time—was $345 billion in 2001. We have said in past testimonies that there are no easy fixes to this problem. But in the face of large and growing structural deficits, it is nevertheless important that the government continues to seek out potential causes and solutions. This is in keeping with another theme that we have emphasized: that fundamental reexamination of government programs, policies, and priorities is necessary to assure that they match the needs of the 21st century. While we do not know the extent to which tax code complexity contributes to the tax gap, this hearing is an important step as Congress considers the role played by tax code complexity in either contributing to the tax gap or impeding progress towards solutions.

My statement today will cover (1) how complexity adds to taxpayer burden and economic efficiency costs; (2) how complexities in reporting

income contribute to the tax gap; (3) how tax expenditures[1] add complexity and contribute to the tax gap; and (4) possible strategies for addressing the tax gap. It is based mostly on our work from 2005 through 2011 on tax compliance issues affecting individual taxpayers. Those performance audits were conducted in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provided a reasonable basis for our findings and conclusions based on our audit objectives.

We have also updated our analyses from our previous work on the number and sum of tax expenditure provisions.[2] To determine the reliability of this data, we reviewed related documentation and tested data for obvious errors. We determined that the data were sufficiently reliable for the purposes of this testimony.

## Background

### Tax Gap

The gross tax gap is an estimate of the difference between the taxes—including individual income, corporate income, employment, estate, and excise taxes—that should have been paid voluntarily and on time and what was actually paid for a specific year.[3] Of the estimated $345 billion tax gap for tax year 2001, IRS estimated that it would eventually recover

[1]Tax expenditures are preferential provisions in the tax code, such as exemptions and exclusions of income from taxation, deductions, credits, deferral of tax liability, and preferential tax rates. Deciding whether an individual provision should be characterized as a tax expenditure is a matter of judgment, and disagreements about classification stem from different views about what should be included in the income tax base. As a practical matter, the term tax expenditure has been used in the federal budget for over three decades, and the tax expenditure concept—while not precisely defined—is a valid representation of one tool that the federal government uses to allocate resources. The home mortgage interest deduction and the Earned Income Tax Credit are examples of tax expenditures.

[2]GAO, *Government Performance and Accountability: Tax Expenditures Represent a Substantial Federal Commitment and Need to Be Reexamined*, GAO-05-690 (Washington, D.C.: Sept. 23, 2005).

[3]Throughout this statement, references to the tax gap refer to the gross tax gap unless otherwise noted.

about $55 billion of that through late payments and enforcement actions, for a net tax gap of $290 billion. The estimate is an aggregate of estimates for the three primary types of noncompliance: (1) underreporting of tax liabilities on tax returns; (2) underpayment of taxes due from filed returns; and (3) nonfiling, which refers to the failure to file a required tax return altogether or on time.[4] We have made many recommendations over time that could address the tax gap.[5]

IRS's tax gap estimates for each type of noncompliance include estimates for some or all of the five types of taxes that IRS administers. Underreporting of tax liabilities can occur when a taxpayer underreports income earned or overclaims deductions from income. As shown in table 1, underreporting of tax liabilities—particularly for the individual income tax—accounted for most of the tax gap estimate for tax year 2001. We have encouraged regular tax gap measurements, and IRS officials have indicated that they will be updating their tax gap estimates later in 2011 or early 2012. We believe that these estimates are important to gauge progress in addressing the tax gap and because analyzing the data used to estimate it can help identify ways to improve tax compliance.

**Table 1: IRS's Tax Year 2001 Gross Tax Gap Estimates by Type of Noncompliance and Type of Tax**

Dollars in billions

| | Type of tax | | | | | |
|---|---|---|---|---|---|---|
| **Type of noncompliance** | **Individual income tax** | **Corporate income tax** | **Employment tax** | **Estate tax** | **Excise tax** | **Total** |
| Underreporting | $197 | $30 | $54 | $4 | No estimate | **$285** |
| Underpayment | 23 | 2 | 5 | 2 | 1 | **34** |
| Nonfiling | 25 | No estimate | No estimate | 2 | No estimate | **27** |
| **Total** | **$244** | **$32** | **$59** | **$8** | **$1** | **$345** |

Source: IRS.

Note: Some figures do not sum to totals because of rounding.

Taxpayers who underreported the amount of individual income tax they owed represented an estimated $197 billion of the 2001 tax gap, and $165

[4]Taxpayers who receive filing extensions, pay their full tax liability by payment due dates, and file returns prior to extension deadlines are considered to have filed on time.

[5]For a summary of key outstanding recommendations, see GAO, *Opportunities to Reduce Potential Duplication in Government Programs, Save Tax Dollars, and Enhance Revenue*, GAO-11-318SP (Washington, D.C.: Mar. 1, 2011).

billion of that amount was due to individual tax filers underreporting their income. As shown in table 2, underreporting of individuals' business income and nonbusiness income accounted for $109 billion and $56 billion, respectively, of the 2001 tax gap.

**Table 2: Components of the Tax Gap for Individual Income Tax Underreporting, Tax Year 2001**

| Type of income or offset | Tax gap amount (dollars in billions) | Net misreporting percentage |
|---|---|---|
| Business income | $109 | 43% |
| Nonbusiness income | 56 | 4 |
| Credits | 17 | 26 |
| Deductions | 14 | 5 |
| Exemptions | 4 | 5 |
| Adjustments | -3 | -21 |
| **Total** | **$197** | **18%** |

Source: IRS.

Note: Figures may not sum to totals because of rounding. Net misreporting percentage is the net amount misreported on a given line item or category expressed as a percentage of the sum of the absolute values of the amounts that should have been reported for that item or category.

IRS has concerns with the certainty of the tax gap estimate for tax year 2001 in part because some areas of the 2001 estimate rely on data originally gathered in the 1970s and 1980s. IRS has no estimates for other areas of the tax gap, and it is inherently difficult to measure some types of noncompliance.[6] Some analysts believe the 2001 estimate likely underestimated the tax gap and that in absolute dollars it is likely larger now than in 2001.

IRS's overall approach to reducing the tax gap consists of improving service to taxpayers and enhancing enforcement of the tax laws. IRS seeks to improve voluntary compliance through efforts such as education and outreach programs and tax form simplification. It also uses its enforcement authority to ensure that taxpayers are reporting and paying the proper amounts of taxes through efforts such as examining tax returns

[6]For a more detailed discussion about data sources and methodologies used in estimating the tax gap, see GAO, *Tax Compliance: Better Compliance Data and Long-term Goals Would Support a More Strategic IRS Approach to Reducing the Tax Gap*, GAO-05-753 (Washington, D.C.: July 18, 2005).

and matching the amount of income taxpayers report on their tax returns to the income amounts reported on information returns[7] it receives from third parties. In spite of IRS's efforts to improve taxpayer compliance, the rate at which taxpayers pay their taxes voluntarily and on time has tended to range from around 81 percent to around 84 percent over the past three decades.

## Tax Expenditures

The sum of the estimated revenue loss due to tax expenditures was over $1 trillion in 2010.[8] Tax expenditures are often aimed at policy goals similar to those of federal spending programs. Existing tax expenditures, for example, help students and families finance higher education and provide incentives for people to save for retirement. Because tax expenditures result in forgone revenue for the government, they have a significant effect on overall tax rates—all else equal, for any given level of revenue, tax expenditures mean that overall tax rates must be higher than a tax system with no tax expenditures. In 2005, we recommended that the federal government take several steps to ensure greater transparency of and accountability for tax expenditures by reporting better information on tax expenditure performance and more fully incorporating tax expenditures into federal performance management and budget review processes.[9]

## Complexity Can Have Value, but Adds to Compliance and Efficiency Costs

The federal tax system contains complex rules. These rules may be necessary, for example, to ensure proper measurement of income, target benefits to specific taxpayers, and address areas of noncompliance. However, these complex rules also impose a wide range of record keeping, planning, computational, and filing requirements upon businesses and

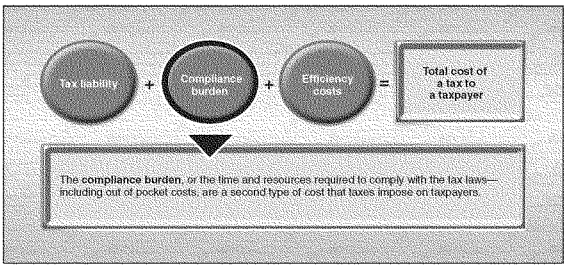
[7]An information return is a tax document businesses and some individuals are required to file to report certain business transactions to the IRS. The requirement to file information returns is mandated by the IRS and associated regulations.

[8]Sums of tax expenditure estimates are useful for gauging the magnitude of tax spending, but need to be interpreted carefully because they do not take into account possible interactions between the individual tax code provisions. These estimates are based on data from the President's Fiscal Year 2012 Budget Request's list of tax expenditures, which is based upon current tax law enacted as of September 30, 2010. On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 not only extended many tax expenditure provisions, but also extended income tax rates for the years 2011-12, thus affecting the estimates of many tax expenditures.

[9]As of May 2011, this recommendation has not been implemented.

individuals. Complying with these requirements costs taxpayers time and money. As shown in figure 1, these costs to taxpayers are above and beyond what they pay to the government in taxes.

**Figure 1: Compliance Burden Is One Cost Taxpayers Face in Complying with the Tax System**




Source: GAO.

Estimating total compliance costs is difficult because neither the government nor taxpayers maintain regular accounts of these costs, and federal tax requirements often overlap with record keeping and reporting that taxpayers do for other purposes. Although available estimates are uncertain, taken together, they suggest that total compliance costs are large. For example, in 2005 we reviewed existing studies and reported that even using the lowest available compliance cost estimates for the personal and corporate income tax, combined compliance costs would total $107 billion (roughly 1 percent of gross domestic product [GDP]) per year; other studies estimate costs 1.5 times as large.[10]

The tax system also results in economic efficiency costs, which are reductions in economic well-being caused by changes in behavior due to taxes, government benefits, monopolies, and other forces that interfere in the market. Efficiency costs can take the form of lost output or consumption opportunities. For example, economists generally agree that

[10]GAO, *Tax Policy: Summary of Estimates of the Costs of the Federal Tax System*, GAO-05-878 (Washington, D.C.: Aug. 26, 2005).

the favorable tax treatment of owner-occupied housing distorts investment in the economy, resulting in too much investment in housing and too little business investment. Estimating efficiency costs associated with the tax system is challenging because it has extensive and diverse effects on behavior. In fact, in a 2005 report, we found no comprehensive estimates of the efficiency costs of the current federal tax system.[11] The two most comprehensive studies we found suggest that these costs are large—on the order of magnitude of 2 to 5 percent of GDP each year (as of the mid-1990s). However, the actual efficiency costs of the current tax system may not fall within this range because of uncertainty surrounding taxpayers' behavioral responses, changes in the tax code and the economy since the mid-1990s, and the fact that the two studies did not cover the full scope of efficiency costs.

Tax software and the use of paid tax return preparers may mitigate the need for taxpayers to understand complexities of the tax code. In 2010, IRS processed about 137 million returns. As we have previously reported, about 90 percent of returns are prepared by individual taxpayers or paid preparers using professional or commercial software. Software companies and paid preparers often act as surrogate tax administrators in that they keep abreast of tax law changes. A participant at the 2007 Joint Forum on Tax Compliance stated that taxpayers receiving assistance in preparing their individual tax returns, either from paid preparers or tax preparation software, are somewhat insulated from tax code complexity.[12]

However, while many paid tax preparers help taxpayers by using their expertise to help ensure that complex laws are understood, others may introduce their own mistakes. For example, in a limited investigation in 2006, all 19 of the tax return preparers who prepared returns for our undercover investigators produced errors, some with substantial consequences.[13] IRS's review of 2001 tax returns also found that tax returns prepared by paid preparers contained a significant level of errors.

[11]GAO-05-878.

[12]GAO, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, GAO-08-703SP (Washington, D.C.: June 2008). GAO, the Congressional Budget Office, and the Joint Committee on Taxation convened the Joint Forum on Tax Compliance.

[13]GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (Washington, D.C.: Apr. 4, 2006). Our findings cannot be generalized to the entire retail tax preparation community.

IRS audits of returns prepared by a paid preparer showed a higher error rate—56 percent—than audits of returns prepared by the taxpayer—47 percent.

## Complexities in Reporting Income Contribute to the Tax Gap by Providing Opportunities for Taxpayers to Misreport

Income measurement is straightforward for a large proportion of the individual taxpayer population: those who earn only labor and interest income and capital income within a retirement account generally have their income reported to them (and to the IRS) by the source of the income. However, substantial numbers of taxpayers who receive income from capital gains, rents, self-employment, and other sources often deal with complex tax laws, complicated calculations, and detailed record keeping. While complexities lead some taxpayers to make mistakes when reporting their income, some misreporting is due to intentional acts of tax evasion.

For example, IRS studies show that the majority of capital asset transactions and capital gains and losses were for securities transactions such as sales of corporate stock, mutual funds, bonds, options, and capital gain distributions from mutual funds. Taxpayers are required to report securities transactions on their federal income tax returns. To accurately report securities sales, the taxpayer must have records of the dates they acquired and sold the asset; sales price, or gross proceeds from the sale; cost or other basis of the sold asset; and resulting gains or losses.[14] They must report this information separately for short-term transactions and long-term transactions. Further, before taxpayers can determine any gains or losses from securities sales, they must determine if and how the original cost basis of the securities must be adjusted to reflect certain events, such as stock splits, nontaxable dividends, or nondividend distributions.

Complex income-reporting requirements for securities transactions may contribute to taxpayers' misreporting their income. In 2006, we estimated that 8.4 million of the estimated 21.9 million taxpayers with securities transactions misreported their gains or losses for tax year 2001.[15] A greater

[14]Basis is generally the amount of a taxpayer's investment in a property for tax purposes.

[15]GAO, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed*, GAO-06-603 (Washington, D.C.: June 13, 2006). We are 95 percent confident that from 7.3 million to 9.5 million taxpayers misreported securities transactions and from 20.3 million to 23.5 million taxpayers had securities transactions.

estimated percentage of taxpayers misreported gains or losses from securities sales (36 percent) than capital gain distributions from mutual funds (13 percent), and most of the misreported securities transactions exceeded $1,000 of capital gain or loss.[16] This may be because taxpayers must determine the taxable portion of securities sales' income whereas they need only add up their capital gain distributions. Furthermore, about half of these taxpayers who misreported failed to accurately report the securities' basis, sometimes because they did not know the basis or failed to adjust the basis appropriately. Although we were not able to estimate the capital gains tax gap for securities, we were able to determine the direction of the misreporting. For securities sales, an estimated 64 percent of taxpayers underreported their income from securities (i.e., they understated gains or overstated losses) compared to an estimated 33 percent of taxpayers who overreported income (i.e., they overstated gains or understated losses).[17] For both underreported and overreported income, some taxpayers misreported over $400,000 in gains or losses.

Small businesses—which include sole proprietorships and S corporations, among other entities—are subject to multiple layers of filing, reporting, and deposit requirements. These requirements reflect IRS's administration of a variety of tax and other policies, including income, employment, and excise taxes, as well as pension and other employee benefit programs. In considering the number of requirements, it is important to note that the requirements reflect many decisions and compromises made by Congress and administrations to accomplish their policy goals, including those that may benefit small businesses and other taxpayers.

Sole proprietors face significant complexities in reporting income. This complexity may contribute to the estimated $68 billion of the tax gap caused by sole proprietors underreporting their net business income, which can stem either from understated receipts or overstated expenses. For example, sole proprietors report their business-related profit or loss on their individual income tax return, and they can use their losses to offset other categories of income on their returns in the year that they incur the loss. Identifying which of a sole proprietor's payments qualify as

[16]Percentage estimates have sampling errors of (+/-) 7 percent or less.

[17]Figures do not sum to 100 percent because some taxpayers misreported securities sales in a way that had no effect on the amount of income from the sales, for example in cases where taxpayers only misreported the securities' holding periods. Estimates have sampling errors of (+/-) 9 percent or less.

business expenses and the amount to be deducted can be complex. For example, two types of payments—costs of goods sold and capital improvements—must be distinguished from other types of payments because they are treated differently under tax rules.[18] Expenses that are used partly for business and personal purposes can be deducted only to the extent they are used for business.

Individual taxpayers who are shareholders in S corporations may also experience difficulty because of complexity in income measurement. An S corporation is a federal business type that provides tax benefits and limited liability protection to shareholders. S corporations are not generally taxed at the entity level: income, losses, and deduction items pass through to the individual shareholders' income tax returns, and the shareholders are taxed on any net income. S corporations are to provide their shareholders and IRS with information on the allocation of income, losses, and other items.

As we have previously reported, one source of complexity for S corporation shareholders may arise when calculating basis—their ownership share of the corporation—in order to claim losses and deductions to offset other earned income.[19] Shareholders generally can only claim losses and deductions up to the amount of basis the shareholder has in the S corporation's stock and debt.[20] While the S corporation is required to send shareholders some information that can be used to calculate basis, S corporations are not required to report any basis calculations to shareholders. IRS officials and S corporation stakeholder representatives told us that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules. In 2009, we

[18]To identify the cost of goods sold, businesses that manufacture or resell merchandise must follow tax rules that require valuing their inventory at the beginning and end of the tax year. Payments for capital improvements, such as start-up costs, business assets, and improvements, usually are not fully deducted in the current tax year but instead must be depreciated over a multiyear period.

[19]GAO, *Tax Gap: Actions Needed to Address Noncompliance with S Corporation Tax Rules*, GAO-10-195 (Washington, D.C.: Dec. 15, 2009).

[20]Stock basis begins with the shareholder's initial capital contribution to the S corporation or the initial cost of the stock purchased. That amount may increase or decrease each year. An income item will increase stock basis; a loss, deduction, or nondividend distribution will decrease stock basis, based on certain ordering rules. For losses and deductions that exceed a shareholder's stock basis, the shareholder is allowed to deduct the excess up to the shareholder's debt basis, which is created by loans that the shareholder personally made to the S corporation.

recommended that Congress require S corporations to calculate shareholder's stock and debt basis as completely as possible and report the calculation to shareholders and IRS.[21] In an analysis of IRS's annual examinations of individual tax returns that closed for fiscal years 2006 through 2008, we found the amount of the misreported losses that exceeded basis limitations was over $10 million, or about $21,600 per taxpayer.

## Tax Expenditures Add Complexity and Contribute to the Tax Gap by Providing Opportunities for Taxpayers to Make Mistakes or Evade Taxes

The growing number of tax expenditures is among the causes of tax code complexity. Between 1974 and 2010, tax expenditures reported by the Department of the Treasury more than doubled in overall number from 67 to 173. Tax expenditures are an important means the government uses to address a wide variety of social objectives, from supporting educational attainment, to providing low-income housing, to ensuring retirement income, and many others. However, tax expenditures add to tax code complexity in part because they require taxpayers to learn about, determine their eligibility for, and choose between tax expenditures that have similar purposes. Tax expenditures also complicate tax planning, as taxpayers must predict their own future circumstances as well as future tax rules to make the best choice among provisions.

Savings incentives within the tax code illustrate how tax expenditures add to complexity. While the tax code includes numerous types of savings incentives—including those for healthcare and higher education—my statement will focus on retirement savings as a key example. Taxpayers can choose between traditional Individual Retirement Arrangements (IRA) and Roth IRAs for retirement savings.[22] Although the tax rules for distributions diverge for traditional and Roth IRAs, taxpayers may not know that a 10 percent early withdrawal penalty, with some exceptions, applies to both IRA types. Taxpayers also get confused over which IRA early withdrawals are not subject to penalties, in part because the exceptions differ for employer pension plans. Additionally, both types of IRAs have rules governing eligibility to contribute, and contributions to

[21] As of December 2010, no action has been taken.

[22] The traditional IRA allows tax deferral on investment earnings until retirement distribution with an up-front tax deduction from taxable income for contributions by eligible taxpayers, and retirement distributions are taxable. In contrast, the Roth IRA allows nondeductible, after-tax contributions for eligible taxpayers, and retirement distributions, including investment earnings, are generally tax-free.

each are subject to an annual limit. However, taxpayers may not understand that the annual contribution limit applies across traditional IRAs and Roth IRAs in combination, which may lead them to overcontribute. With regard to record-keeping burden, taxpayers with traditional or Roth IRAs must track the total amount of contributions in a given year and reasons for distributions to accurately report this information on their tax returns. Frequent changes to IRA rules (such as increasing contribution limits and allowing workers to tap IRA assets for certain nonretirement purposes without an early withdrawal penalty) have also made tax planning more difficult for taxpayers.

As we reported in 2008, IRS research and enforcement data show that—in the aggregate—many taxpayers misreported millions of dollars in traditional IRA contributions and distributions on their tax returns.[23] We reported that in tax year 2001 the following occurred:

- Of the taxpayers who made deductible traditional IRA contributions, an estimated 14.8 percent[24] (554,657 taxpayers)[25] did not accurately report the IRA deduction on their individual tax returns—10.4 percent overstated their deductible contributions (that is, exceeded the applicable limit) and 4.4 percent underreported their deductible contributions (that is, reported less on their returns than they actually could deduct).[26] The understated net income due to these misreported traditional IRA contribution deductions was $392 million,[27] including both taxpayers who either overstated or understated their contribution deductions to a traditional IRA.

[23]GAO, *Individual Retirement Accounts: Additional IRS Actions Could Help Taxpayers Facing Challenges in Complying with Key Tax Rules*, GAO-08-654 (Washington, D.C.: Aug. 14, 2008).

[24]We are 95 percent confident that from 11.8 percent to 17.8 percent did not accurately report their traditional IRA deductions.

[25]Estimate has a margin of error of less than or equal to (+/-) 124,057.

[26]We are 95 percent confident that from 7.9 percent to 13.3 percent overstated their traditional IRA deductions. We are 95 percent confident that from 2.8 percent to 6.5 percent understated their traditional IRA deductions.

[27]Estimate has a margin of error of less than or equal to (+/-) $192 million.

- Of the taxpayers who had taxable traditional IRA distributions, an estimated 14.6 percent[28] (1.5 million taxpayers)[29] misreported withdrawals from their traditional IRA distributions—13.7 percent understated (that is, reported an amount less than what the taxpayer withdrew) and 0.9 percent overstated IRA distributions (that is, reported an amount greater than what the taxpayer withdrew).[30] The underreported net income due to misreported IRA distributions was $6.3 billion,[31] including taxpayers who failed to report early distributions and the associated tax.

Taxpayers also make costly mistakes when choosing higher-education tax incentives. In a 2008 testimony, we reported that among tax filers who appeared to be eligible for a tax credit or tuition deduction in tax year 2005, about 19 percent, representing about 412,000 returns, failed to claim any of them.[32] The amount by which these tax filers failed to reduce their tax averaged $219; 10 percent of this group could have reduced their tax liability by over $500. In total, including both those who failed to claim a tax credit or tuition deduction and those who chose a credit or a deduction that did not maximize their benefit, we found that in 2005, 28 percent, or nearly 601,000 tax filers, did not maximize their potential tax benefit.

Some tax expenditures also provide taxpayers who intend to evade taxes with opportunities to do so. For example, the Treasury Inspector General for Tax Administration (TIGTA) reported in 2011 that the First-time Homebuyer Credit (FTHBC) and the subsequent changes made to the credit have confused taxpayers and allowed individuals to make

[28]We are 95 percent confident that from 12.7 percent to 16.6 percent did not accurately report their traditional IRA distributions.

[29]Estimate has a margin of error of less than or equal to (+/-) 220,026.

[30]We are 95 percent confident that from 11.8 percent to 15.7 percent underreported their traditional IRA distributions. We are 95 percent confident that from 0.5 percent to 1.4 percent overreported their traditional IRA distributions.

[31]Estimate has a margin of error of less than or equal to (+/-) $2.2 billion.

[32]GAO, *Higher Education: Multiple Higher Education Tax Incentives Create Opportunities for Taxpayers to Make Costly Mistakes*, GAO-08-717T (Washington, D.C.: May 1, 2008).

fraudulent claims for the refundable credit.[33] For example, TIGTA reported many taxpayers claiming the credit appeared not to be first-time homebuyers because tax information indicated they had owned homes within 3 years prior to their new home purchase. The 2008 FTHBC provided taxpayers a refundable credit of up to $7,500 that must be repaid in $500 increments each year over 15 years beginning in the 2011 filing season.[34] According to recent IRS data, the total amount to be repaid by taxpayers is $7 billion. The American Recovery and Reinvestment Act of 2009 increased the maximum FTHBC credit to $8,000, with no payback required unless the home ceases to be the taxpayer's principal residence within 3 years. In 2009, we testified that IRS faced significant challenges in determining if taxpayers were complying with the numerous conditions for the credit.[35] For example, to determine eligibility, IRS had to verify that taxpayers had not owned a house in the previous 3 years and verify the closing date on home purchases. Other challenges included enforcing the $500 per year payback provision in the 2008 credit.

## Strategies to Reduce the Tax Gap Present Challenges and Trade-offs

Multiple approaches are needed to reduce the tax gap. No single approach is likely to fully and cost-effectively address noncompliance since the noncompliance has multiple causes and spans different types of taxes and taxpayers. While the tax gap will remain a challenge into the future, the following strategies could help. These strategies could require actions by Congress or IRS.

### Enhancing Information Reporting

Enhancing information reporting can reduce complexity for taxpayers. It can also reduce the opportunities available for taxpayers to evade taxes by, for example, underreporting business income or filing fraudulent claims for tax credits. Generally, new requirements on third parties to submit information returns would require statutory changes, whereas

[33]Treasury Inspector General for Tax Administration, *Recovery Act: Administration of the First-Time Homebuyer Credit Indicates a Need for Improved Controls Over Refundable Credits*, 2011-41-035 (Washington, D.C.: Mar. 31, 2011).

[34]The FTHBC is a refundable tax credit, meaning that it is paid out even if there is no tax liability or the credit exceeds the amount of any tax due.

[35]GAO, *First-Time Homebuyer Tax Credit: Taxpayers' Use of the Credit and Implementation and Compliance Challenges*, GAO-10-166T (Washington, D.C.: Oct. 22, 2009).

improvements to existing information-reporting forms may be done administratively by IRS.

The extent to which individual taxpayers accurately report the income they earn has been shown to be related to the extent to which the income is reported to them and IRS by third parties or taxes on the income are withheld. For example, employers report most wages, salaries, and tip compensation to employees and IRS through Form W-2. Also, banks and other financial institutions provide information returns (Forms 1099) to account holders and IRS showing the taxpayers' annual income from some types of investments. Findings from IRS's study of individual tax compliance indicate that nearly 99 percent of these types of income are accurately reported on individual tax returns. For types of income for which there is little or no information reporting, individual taxpayers tend to misreport over half of their income.

One area where improved information reporting could help is higher-education expenses. Eligible educational institutions are required to report information on qualified tuition and related expenses for higher education to both taxpayers and IRS so that taxpayers can determine the amount of educational tax benefits that can be claimed.[36] However, the information currently reported by educational institutions on tuition statements sent to IRS and taxpayers (on Form 1098-T) may be confusing for taxpayers who use the form to prepare their tax returns and not very useful to IRS. IRS requires institutions to report on Form 1098-T either the (1) amount of payments received, or (2) amount billed for qualified expenses. IRS officials stated that most institutions report the amount billed and do not report payments. However, the amount billed may not equal the amount that can be claimed as a credit.[37] In order to reduce taxpayer confusion and enhance compliance with the eligibility requirements for higher-education benefits, in 2009 we recommended that IRS revise Form 1098-T

[36]26 U.S.C. § 6050S. Qualified expenses are tuition and fees a student must pay to be enrolled at or attend an eligible educational institution, and other course-related fees and expenses only if the fees and expenses must be paid to the institution as a condition of enrollment or attendance.

[37]Currently, educational institutions are required to report information on the form 1098-T for qualified tuition expenses as well as information on the institution itself and the student. These requirements include, for example, reporting name, address, and taxpayer identification number (TIN) of the institution; name, address, and TIN of the student; and amount of payments received or the amount billed for qualified expenses during the calendar year.

to improve the usefulness of information on qualifying education expenses.[38]

Another area where improved information reporting could improve compliance is rental income. In 2008, we estimated that at least 53 percent of individual taxpayers with rental real estate misreported their rental real estate activities for tax year 2001, resulting in an estimated $12.4 billion of net misreported income.[39] IRS enforcement officials cited limited information reporting as a major challenge in ensuring compliance because without third-party information reporting, it is difficult for IRS to systematically detect taxpayers who fail to report any rent or determine whether the rent and expense amounts taxpayers report are accurate. In 2008, we recommended that IRS require third parties to report mortgaged property addresses to help IRS identify who may have misreported their rental real estate activity, but IRS did not adopt our recommendation because of third-party burden and a lack of an IRS compliance program to use such information. We made a similar recommendation in a 2009 report, which IRS is still evaluating as of December 2010.[40]

While information reporting reduces the complexity of reporting income for individual taxpayers, this tool can create costs for the third parties responsible for reporting the income to the taxpayer and IRS. For example, we previously reported that expanding information reporting on securities sales to include basic information would involve challenges for brokers and the IRS.[41] In particular, brokers would bear costs and burdens—even as taxpayers' costs and burdens decrease somewhat—and

[38]GAO, *2009 Tax Filing Season: IRS Met Many 2009 Goals, but Telephone Access Remained Low, and Taxpayer Service and Enforcement Could Be Improved*, GAO-10-225 (Washington, D.C.: Dec. 10, 2009). In December 2010, IRS agreed to consider the feasibility of using Form 1098-T information in conjunction with its examination program.

[39]GAO, *Tax Gap: Actions That Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[40]We recommended that IRS require third parties to provide information on the address of a home securing a mortgage, among other items. GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009).

[41]GAO-06-603. We reported that, among other things, Congress may wish to consider requiring brokers to report to both taxpayers and IRS the adjusted basis of securities that taxpayers sell. Congress included a provision requiring brokers to report basis information to IRS and taxpayers in the Energy Improvement and Extension Act of 2008. The provision took effect on January 1, 2011, and the Joint Committee on Taxation estimated the provision is expected to raise $6.7 billion in revenue through 2018.

many issues would arise about how to calculate adjusted basis, which securities would be covered, and how information would be transferred among brokers.

In some cases it is difficult to identify third parties for whom a reporting requirement could be enforced without an undue burden on both the third parties and IRS. In a 2009 report, we found that a major reason why little information reporting on sole proprietor expenses exists is because of the difficulty identifying third parties.[42] For example, there is no third party who could verify the business use of cars or trucks by sole proprietors.

## Ensuring High-Quality Services to Taxpayers

Ensuring high-quality services is a necessary foundation for voluntary compliance, so action by IRS to improve the quality of services provided to taxpayers would be beneficial. High-quality services can help taxpayers who wish to comply but do not understand their obligations. IRS taxpayer services include education and outreach programs, simplifying the tax process, and revising forms and publications to make them electronically accessible and more easily understood by diverse taxpayer communities. For example, if tax forms and instructions are unclear, taxpayers may be confused and make unintentional errors. Ensuring high-quality taxpayer services would also be a key consideration in implementing any of the approaches for tax gap reduction. For example, expanding enforcement efforts would increase interactions with taxpayers, requiring processes to efficiently communicate with taxpayers. Changing tax laws and regulations would also require educating taxpayers about the new requirements in a clear, timely, and accessible manner. For example, we previously reported that while taxpayers' access to telephone assistance in tax year 2009 was better than the previous year, it remained lower than in 2007, in part because of calls about tax law changes.[43] Despite heavy call volume, the accuracy of IRS responses to taxpayers' questions remained above 90 percent.

## Simplifying the Tax Code or Fundamental Tax Reform

Congressional efforts to simplify the tax code and otherwise alter current tax policies may help reduce the tax gap by making it easier for individuals and businesses to understand and voluntarily comply with their tax obligations. One way to simplify the tax code is to eliminate or combine

[42]GAO, *Tax Gap: Sole Proprietor Loss Deductions Could Improve Compliance but Would Also Limit Some Legitimate Losses*, GAO-09-815 (Washington, D.C.: Sept. 10, 2009).

[43]GAO-10-225.

tax expenditures, thereby helping reduce taxpayers' unintentional errors and limiting opportunities for tax evasion. As we have previously testified, the Government Performance and Results Act (GPRA) Modernization Act of 2010 (GPRAMA)[44] could help inform reexamination or restructuring efforts and lead to more efficient and economical executive-branch service delivery in overlapping program areas. The act is intended to identify the various agencies and federal activities—including spending programs, regulations, and tax expenditures—that contribute to crosscutting outcomes.[45]

While simplification can have benefits, it can also have drawbacks. Eliminating tax expenditures would reduce the incentives for the activities that were encouraged. Also, in 2005, we stated that changes to the tax system can create winners and losers.[46] The government may attempt to mitigate large gains and losses by implementing transition rules. Deciding if transition relief is necessary involves how to trade off between equity, efficiency, simplicity, transparency, and administrability.

Similar trade-offs exist with possible fundamental tax reforms that would move away from an income tax system to some other system, such as a consumption tax, national sales tax, or value-added tax. Fundamental tax reform would most likely result in a smaller tax gap if the new system has few tax preferences or complex tax code provisions and if taxable transactions are transparent. However, these characteristics are difficult to achieve in any system and experience suggests that simply adopting a fundamentally different tax system, whatever the economic merits, may not by itself eliminate any tax gap. For example, in 2008, we reported that some available data indicate a value-added tax may be less expensive to administer than an income tax. However, we found that like other systems, even a simple value-added tax—one that exempts few goods or services—has compliance risks and, largely as a consequence, generates

[44]Pub. L. No. 111-352, 124 Stat. 3866 (Jan. 4, 2011). GPRAMA amends the Government Performance and Results Act of 1993, Pub. L. No. 103-62, 107 Stat. 285 (Aug. 3, 1993).

[45]GAO, *Government Performance: GPRA Modernization Act Provides Opportunities to Help Address Fiscal, Performance, and Management Challenges*, GAO-11-466T (Washington, D.C.: Mar. 16, 2011).

[46]GAO, *Understanding the Tax Reform Debate: Background, Criteria, & Questions*, GAO-05-1009SP (Washington, D.C.: September 2005).

administrative costs and compliance burden.[47] Similar to other taxes, adding complexity through exemptions or reduced rates for some goods or services generally decreases revenue and increases compliance risks because of the incentive to misclassify purchases and sales. Such complexity also increases the record-keeping burden on businesses and increases the government resources devoted to enforcement.

Any tax system could be subject to noncompliance, and its design and operation, including the types of tools made available to tax administrators, will affect the size of any corresponding tax gap. Further, the motivating forces behind tax reform include factors beyond tax compliance, such as economic effectiveness, equity, and burden, which could in some cases carry greater weight in designing an alternative tax system than ensuring the highest levels of compliance.

Policymakers may find it useful to compare any proposed changes to the tax code based on a set of widely accepted criteria for assessing alternative tax proposals. These criteria include the equity, or fairness, of the tax system; the economic efficiency, or neutrality, of the system; and the simplicity, transparency, and administrability of the system. These criteria can sometimes conflict, and the weight one places on each criterion will vary among individuals. Our publication, *Understanding the Tax Reform Debate: Background, Criteria, and Questions*, may be useful in guiding policymakers as they consider tax reform proposals.[48]

## Devoting Additional Resources to Enforcement

Devoting additional resources to enforcement has the potential to help reduce the tax gap by billions of dollars. However, determining the appropriate level of enforcement resources to provide IRS requires taking into account factors such as how effectively and efficiently IRS is currently using its resources, how to strike the proper balance between IRS's taxpayer service and enforcement activities, and competing federal funding priorities. If Congress were to provide IRS more enforcement

[47]GAO, *Value-Added Taxes: Lessons Learned from Other Countries on Compliance Risks, Administrative Costs, Compliance Burden, and Transition*, GAO-08-566 (Washington, D.C.: Apr. 4, 2008). The value-added tax is a consumption tax that is widely used around the world. A value-added tax is levied on the difference between a business's sales and its purchases of goods and services. Typically, a business calculates the tax due on its sales, subtracts a credit for taxes paid on its purchases, and remits the difference to the government.

[48]GAO-05-1009SP.

resources, the amount that the tax gap could be reduced depends in part on factors such as the size of budget increases, how IRS manages any additional resources, and the indirect increase in taxpayers' voluntary compliance resulting from expanded enforcement. Providing IRS with additional funding would enable it to contact millions of potentially noncompliant taxpayers it currently identifies but cannot contact given resource constraints.

However, devoting additional resources to enforcement will not completely close the tax gap. For example, in a 2009 report, we reported that IRS's compliance programs focused on sole proprietors' underreporting of income addressed only a small portion of sole proprietor expense noncompliance.[49] Despite investing nearly a quarter of all revenue agent time in 2008, IRS was able to examine (audit) about 1 percent of estimated noncompliant sole proprietors. These exams are costly and yielded less revenue than exams of other categories of taxpayers, in part because most sole proprietorships are small in terms of receipts.

## Expanding Compliance Checks Before IRS Issues Refunds

IRS could reduce the tax gap by expanding compliance checks before issuing refunds to taxpayers. In April 2011, the Commissioner of Internal Revenue talked about a long-term vision to increase compliance activities before refunds are sent to taxpayers. In one example, IRS is exploring a requirement that third parties send information returns to IRS and taxpayers at the same time as opposed to the current requirement that some information returns go to taxpayers before going to IRS. The intent is to move to matching those information returns to tax returns during tax return processing. IRS currently matches data provided on over 2 billion information returns to tax returns only after the normal filing season. Matching during the filing season would allow IRS to detect and correct errors before it sends taxpayers their refunds, thereby avoiding the costs of trying to recover funds from taxpayers later.[50] This approach could also allow IRS to use its enforcement resources on other significant compliance problems. However, the Commissioner made clear that his vision for more prerefund compliance checks will take considerable time to implement. One prerequisite would be a major reworking of some

[49]GAO-09-815.

[50]GAO, *Taxpayer Account Strategy: IRS Should Finish Defining Benefits and Improve Cost Estimates*, GAO-11-168 (Washington, D.C.: Mar. 24, 2011).

fundamental IRS computer systems. To the extent that implementing this vision would require additional budgetary resources or changes in tax policies, Congress would play a key role.

## Using Consistent Definitions

If Congress changed the law to include more consistent definitions across tax provisions, then taxpayers could more easily understand and comply with their obligations. Higher-education tax preferences provide an example of inconsistent definitions for qualified education expenses. What tax filers are allowed to claim as a qualified higher-education expense varies between some of the various savings and credit provisions in the tax code. For example, while Coverdell education savings accounts and qualified tuition programs under section 529 of the Internal Revenue Code permit tax filers to include room and board as qualified expenses if the student is enrolled at least half time, the American Opportunity Credit and the Lifetime Learning Credit do not. These dissimilar definitions require that tax filers keep track of expenses separately, applying some expenses to some tax preferences, but not others.

There are no easy solutions to the tax gap, but addressing the tax gap is as important as ever before in the face of the nation's fiscal challenges. Innovative thinking and the combined efforts of IRS and Congress will be needed now and in the years to come.

Chairman Baucus, Ranking Member Hatch, and Members of the Committee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

## Contact and Acknowledgments

For further information on this testimony, please contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov. In addition to the individual named above, David Lewis, Assistant Director; Shannon Finnegan, analyst-in-charge; Sandra Beattie; Amy Bowser; Barbara Lancaster; John Mingus; Erika Navarro; Melanie Papasian; and Jonathan Stehle made key contributions to this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement.

Testimony of Kris Carpenter
Founder/CEO
Sanctuary Spa & Salon
Billings, Montana
Before the United States Senate Finance Committee

June 28, 2011

Chairman Baucus and Members of the Committee, my name is Kris Carpenter and I am a salon and spa owner from Billings, Montana. Thank you for the opportunity to testify before you about what I have experienced in my industry regarding tax compliance.

I opened Sanctuary in 1998 and have been in business for 13 years. In 2010, I opened 2 new businesses: The Joy of Living-a gift store for women and The Joy of Kids-a children's gift store. I employ 40 women in my 3 businesses, 22 of them are salon and spa service providers that accept tip income and 8 guest service members receive tips from a tip-out pool provided by the service providers.

In addition to running my salon and two other retail businesses, I am a member of the Professional Beauty Association (PBA). PBA has over 8,000 members representing salon and spa owners, manufacturers and distributors of salon and spa products, and individual licensed cosmetologists.

Small businesses are the backbone of America's economy and the salon industry is an industry of small businesses. 82% of salon establishments with payroll employees have fewer than 10 payroll employees. According to 2008/2009 data, the salon industry is a vibrant and growing part of the U.S. economy, with more than 900,000 establishments and annual sales of nearly $40 billion. More than 1.1 million professionals work in personal appearance occupations industry-wide and one out of three do so in self-employment rather than employment-based situations; a fact that is central to the salon and spa problem of tax complexity and compliance.

Senator Snowe's introduction of S. 974, the Small Business Tax Equalization and Compliance Act, is promising news to me and my fellow salon owners. The legislation originally came about because salon owners, like me, contacted Congress about the widespread problems associated with tip reporting. In addition to extending existing law to permit salon employers to claim the 45(b) tip tax credit that's currently available only to restaurant employers with tipped employees, the bill also provides much needed assistance to the federal government by improving tip reporting in all sectors of the salon industry.

The expanded credit is a matter of fairness and directly relates to compliance issues. Like the restaurant industry, salon owners must collect and report tip information

from its employees to the Internal Revenue Service (IRS), and pay FICA taxes on the reported tips. However, unlike the restaurant industry, salons are not eligible to claim the tax credit for FICA taxes paid on tips.

The credit would also serve as an offset to the significant costs related to complying with tip tax laws. We must educate employees about tip reporting laws, persuade our employees to comply, keep records of reported tips, and report the income to the IRS. Additional costs of accepting tips on credit cards along with the fact that many credit card companies charge extra fees for tip transactions add to a small business owner's costs. The salon employer is facing a matching FICA liability equal to 7.65% of tips earned and the additional administrative costs. The actual full cost to the employer is closer to 10%. The extension of the 45(b) tax credit to salon owners will bring needed tax relief to help offset the costs of complying.

One of the greatest compliance challenges as an employer is being put in an adversarial position with employees in an industry where employment isn't the only way to receive income. Worker classification is the issue that separates salons from other tipped industries. Unlike most tipped industries, a significant segment of the salon industry is classified as self-employed. While two salons may look the same, one may classify the people behind the chairs as employees while the other may classify its workers as self-employed (or independent contractors). The focus on tips in employment situations is encouraging employees to leave employment for self-employment, and leads employers to reclassify their workers as self-employed.

The bottom line is that the tip-reporting burden is greatest on small business owners and compliance efforts need to be approached with these dynamics in mind. Self-employment is significant and growing. If casino employees are expected by their employer to report all of their tips, they cannot unplug their roulette tables and set up down the street. A waitress cannot just take her tables and open a basement cafe. But a hairdresser or massage therapist can easily find a less formal "self-employment" situation, where there is no employer to withhold from them.

The compliance portion of S. 974 adds simple information reporting requirements to salons with employees and salons that classify their workers as self-employed, in addition to requiring that salon owners provide educational materials to their workers on tip reporting.

While it is possible that some individuals working in such a manner report all of their tips and income as self-employment income, it is well documented that the lack of third party reporting and withholding reduces compliance. There is no question that the greatest source of compliance is a paycheck subject to withholding. So what's at risk here for salons is not only the reporting of tips and the related expense, but the loss of employees. What's at risk for the Treasury is not just the reporting of tips, but the reporting of income altogether.

Submitted with this testimony is an overview of the salon industry that indicates the size of the non-employed sector.

These are not just statistics for me. In 2010, the average hourly wage of all of my 22 service providers (half are full-time and half are part-time employees) was $14.31 an hour and the average reported tip income was $6.33 an hour before their 10% tip-out to support staff (who pay their own taxes on the tip-out). I pay my employees a fair wage, pay 65% of full-time employee's health insurance premiums, and provide them with a 401(k) and profit sharing opportunities. (Benefits you would not find in a "self-employment" position.)

Ten years ago, Sanctuary began recording in our point of sale software the tips received by our employees. It is recorded for the employee in the guest's name and the amount of tips received. Daily, our bookkeeper deposits the tip income into a tip holding checking account until the next payroll date when the tips are paid to the employees along with their regular paycheck. Taxes are withheld and paid and the FICA match is paid by Sanctuary.

To me, the amount recorded was astounding. On average, prior to this accounting, I estimate that 25% of the actual tip income was reported to Sanctuary by our employees and paid to the IRS. Over this 10-year period, we will have reported $1.7 million in tip income from our employees. And remember, I am a salon in Billings, Montana where our average service sales ticket is only $46. In 2010, we reported tip income of $225,261. Tip income in 2010 was 15.1% of our service sales. The cost to the company to match the FICA taxes on the employee's tip income was $16,387. This places a significant burden on my business' ability to stay profitable while continuing to provide other benefits for our employees.

I believe it is vital for my employees to report all of their income in order to create a better future. A few years ago, I had a banker do a projection of 10 of my highest income employees' ability to qualify for a first-time homebuyer loan. Without their tip income reported, only 1 employee would have qualified for this loan to purchase their first home. With tip income reported, 6 more of my employees would be qualified buyers.

Over the past 10 years, I have lost several employees to the lure of "renting a chair." It takes up to 2 years for Sanctuary to train a newly licensed cosmetologist to perform the services my business offers our guests. Because Sanctuary pays an hourly wage, these new employees are paid for every hour worked and all training time. After this investment, we have experienced the effects of a work force able to "rent a chair" and take our business' customers with them. The ease of not reporting income and tip income along with the common misconception that "tips are gifts-not income" by individuals in my industry puts my business at a competitive disadvantage.

I believe it's unfair that individuals in our industry are able to take an extra $5+ an hour in unreported income. Teachers, soldiers, bankers, grocery clerks and other workers in this country aren't allowed that "choice" with their income. I'd like to see the gap in this unlawful practice narrowed.

Doing the right thing should not put people at a disadvantage to those who do not.

**Suggestions:**

1. **Congress should pass S. 974.**

   The low-cost provisions of S.974 have bipartisan support in Congress. Salon owners reluctant to comply because of the costs of the FICA match will be relieved of that burden. It will help the salon industry and the Treasury will increase its collections of taxes owed.

2. **The IRS needs to systemize contacts with the self-employed.**

   It is the IRS's contact with the employers in the industry that has increased compliance in that segment. There is not an equal level of contact with the self-employed.

   The compliance provision of S. 974 would systemize taxpayer contacts by requiring that the correct form be issued to self-employed workers by the establishment. In a simple way, this third party action provides a point of contact for the IRS.

3. **The IRS needs to connect the license with the tax filer.**

   The most universal arm of government in the salon industry is the state board. It's the one place where everyone in the industry meets. Every individual needs a professional license before they begin practicing. Every salon needs a facility license before they can open. Licenses need to be classified according to taxpayer type. This would provide a cross-reference link for both the individual and the business.

I thank you for this opportunity to share some ideas.

I appreciate your support for our industry of small businesses, look forward to working together toward a long-term solution and I welcome your questions and comments.

Thank you.

# *Economic Snapshot of the Salon and Spa Industry*

professional beauty association pba

June 2011

**Salon Industry Snapshot**

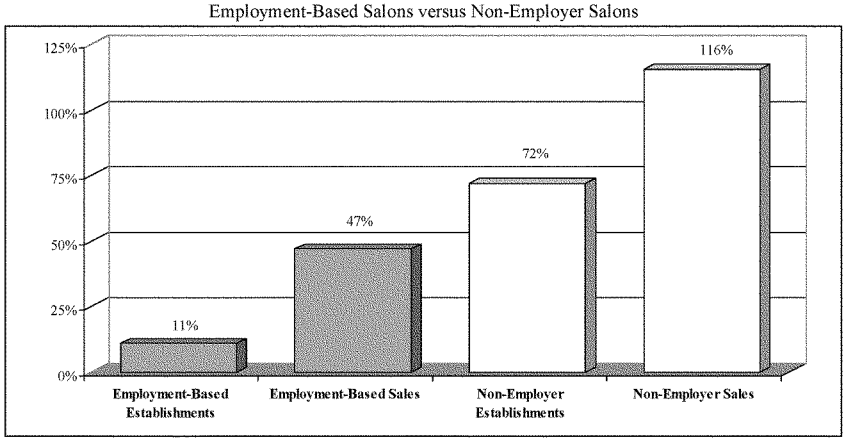
- The salon and spa industry is a vibrant and growing component of the U.S. economy, with more than 900,000 total establishments and annual sales of nearly $40 billion.

| | |
|---|---|
| **Salon Establishments With Payroll Employees** | |
| 2009 Establishments | 88,876 |
| 2009 Sales | $21.2 billion |
| **Non-Employer Salon Establishments*** | |
| 2008 Establishments | 824,119 |
| 2008 Sales | $18.8 billion |

Source: Bureau of Labor Statistics, U.S. Census Bureau; 2008/2009 figures

- The salon and spa industry registered steady growth over the last decade, with the strongest gains seen in the non-employer sector. The number of non-employer salon and spa establishments increased 72 percent in the last decade, while their sales jumped 116 percent. In comparison, the number of employment-based salon and spa establishments increased 11 percent over the last decade, with their sales rising 47 percent.

**Salon Industry Establishment and Sales Growth Over the Last Decade**
Employment-Based Salons versus Non-Employer Salons



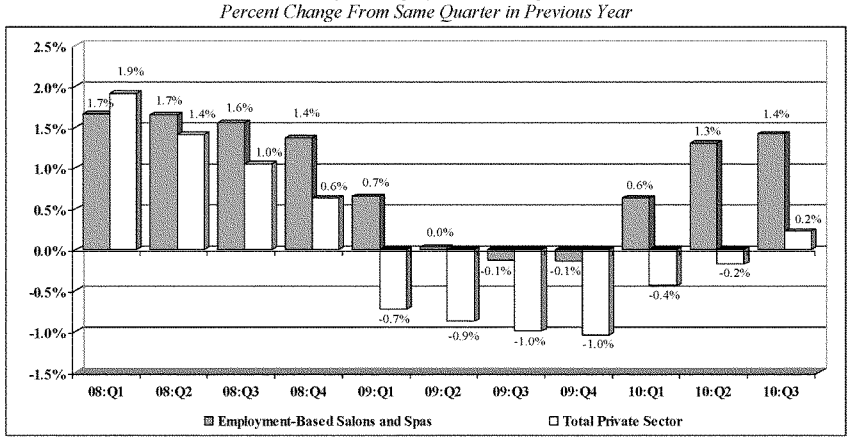

Source: Bureau of Labor Statistics, U.S. Census Bureau

*A Non-Employer Establishment is a business entity that has no paid employees. For data purposes the federal government counts each distinct business income tax return filed by a non-employer business as an establishment. As a result, an individual such as an independent contractor could be classified as a non-employer establishment. Non-employer businesses may operate from a home address or a separate physical location. Examples of non-employer establishments in the salon industry could include 1) a small salon business owned and operated by one individual, where this individual provides all of the services, 2) a salon business of any size that does not have regular paid employees, but may have independent contractors working in their establishment, 3) an individual that leases a chair as an independent contractor, 4) an individual that cuts hair out of their home, and 5) an individual that provides salon-related services as an independent contractor in the entertainment or fashion industries.

**The Salon and Spa Industry Outperformed the Overall Private Sector During the Recession**

- The Great Recession of the late 2000s took a tremendous toll on the nation's private sector. At the depth of the recession, the national economy was losing tens of thousands of businesses each quarter. Between the fourth quarters of 2008 and 2009, the national economy experienced a net loss of more than 92,000 private-sector business establishments – a decline of one percent.
- In comparison, the nation's salon and spa industry performed relatively well during the recession. Although growth in the number of employment-based salons and spas slowed during the recession and briefly turned negative, the declines were much less severe than the overall private sector. Between the fourth quarters of 2008 and 2009, the salon and spa industry experienced a net decline of only 130 establishments – or just 0.1 percent.

**Salon and Spa Industry Outperformed the Private Sector During the Recession**
Number of Establishments with Payroll Employees: Salons/Spas vs. Total U.S. Private Sector
*Percent Change From Same Quarter in Previous Year*



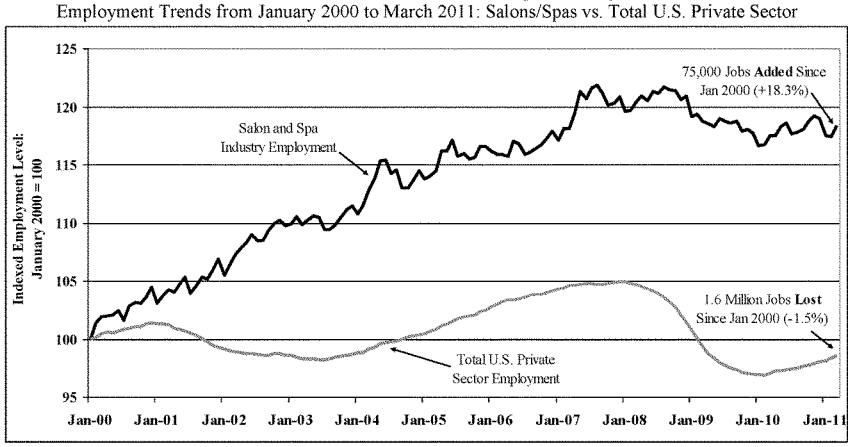

Source: Profession Beauty Association analysis of data from the Bureau of Labor Statistics

**The Salon and Spa Industry Provided Much Needed Job Growth During the Lost Decade**

- One only has to look at recent history to see that the salon and spa industry is an engine of job growth for the U.S. economy, even when many other industries are shedding jobs. During the challenging economic period of the last 11 years that included two recessions, job growth in the U.S. economy stagnated. In fact, there were 1.6 million fewer private sector jobs in the economy in March 2011 than there were in January 2000 – a decline of 1.5 percent.
- In contrast, employment-based salons and spas added 75,000 jobs during the same period, which represented an increase of more than 18 percent. This substantial growth occurred despite back-to-back job losses in 2009 and 2010, when the salon industry was negatively impacted by the recession. Overall, salon industry job growth outperformed the overall economy in nine of the last 11 years.

**No Lost Decade for the Salon and Spa Industry**

Employment Trends from January 2000 to March 2011: Salons/Spas vs. Total U.S. Private Sector

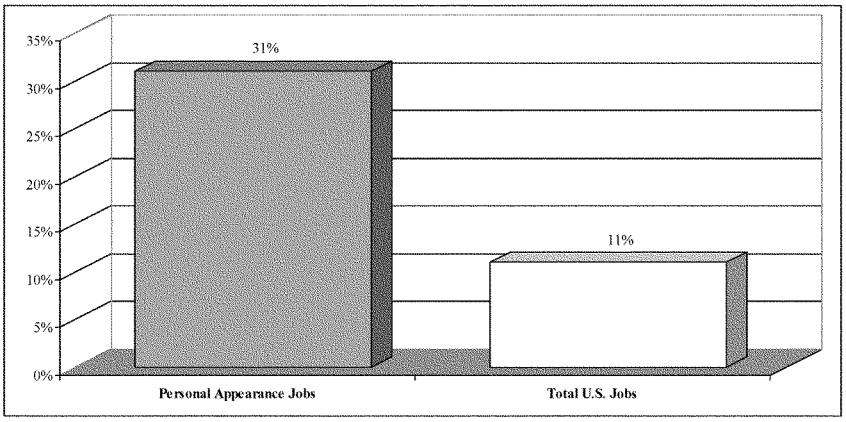



Source: Profession Beauty Association analysis of data from the Bureau of Labor Statistics

**The Salon and Spa Industry is Projected to Post Steady Job Growth in the Future**

- Not only did the salon and spa industry provide much needed job growth during the sluggish last decade, it is poised to post steady growth well into the future. According to the Bureau of Labor Statistics, the number of personal appearance jobs is projected to jump 31 percent between 2008 and 2018, nearly three times the rate of growth of total U.S. employment (11 percent) during the same period.
- All of the major personal appearance occupations are projected to post job growth stronger than the overall economy between 2008 and 2018. The number of skin care specialist jobs is projected to jump 51 percent, while hairdresser, hairstylist and cosmetologist positions are expected to increase by 31 percent.

**Projected Job Growth: 2008 to 2018**
*Wage and Salary Employment*




**Source:** U.S. Department of Labor, Bureau of Labor Statistics

**Projected Salon Industry Job Growth: 2008 to 2018**
*Wage and Salary Employment*

| Occupation | Job Growth: 2008 to 2018 |
|---|---|
| Skin Care Specialists | 51% |
| Hairdressers, Hairstylists, and Cosmetologists | 31 |
| Manicurists and Pedicurists | 24 |
| Makeup Artists, theatrical and performance | 21 |
| Shampooers | 20 |
| Barbers | 12 |
| TOTAL PERSONAL APPEARANCE JOBS | 31% |

Source: U.S. Department of Labor, Bureau of Labor Statistics

**One Out of Three Salon-Industry Professionals is Self-Employed**

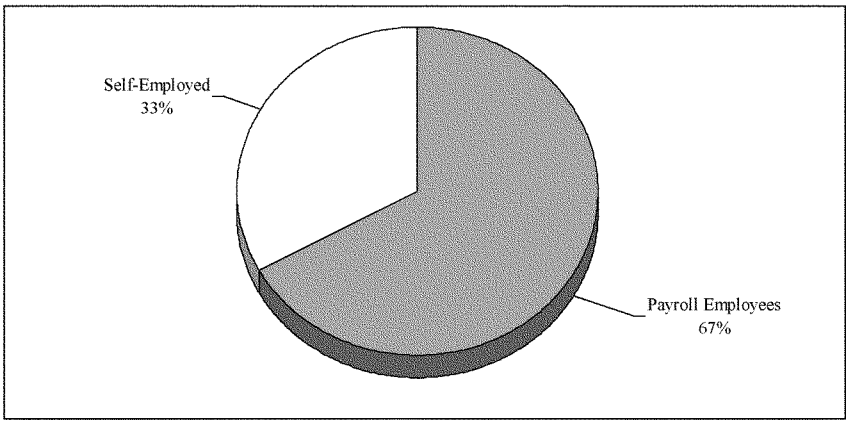
- Overall, more than 1.1 million professionals work in personal appearance occupations in the United States, according to the Bureau of Labor Statistics. Individuals in these occupations have a much higher rate of self-employment, as compared to the overall workforce.
- Thirty-three percent of all individuals in personal appearance occupations are self-employed. In comparison, only seven percent of the overall U.S. workforce is self-employed.
- Of the 770,000 Hairdressers, Hairstylists and Cosmetologists, 35 percent (or 267,000) are self-employed.
- Barbers have the highest proportion of self-employed individuals, at 54 percent.

**Number of Individuals in Personal Appearance Occupations**

| Personal Appearance Occupation | Total Employees in Occupation | Self-Employed Proportion | Total Self-Employed in Occupation |
|---|---|---|---|
| Hairdressers, Hairstylists, and Cosmetologists | 770,000 | 35% | 267,000 |
| Barbers | 96,000 | 54 | 52,000 |
| Other Personal Appearance Workers* | 273,000 | 19 | 53,000 |
| TOTAL INDIVIDUALS IN PERSONAL APPEARANCE OCCUPATIONS | 1,139,000 | 33% | 372,000 |

Source: U.S. Department of Labor, Bureau of Labor Statistics; 2010 data
*Includes the following occupations: Makeup Artists, theatrical and performance; Manicurists and Pedicurists; Shampooers; and Skin Care Specialists

**Distribution of Individuals in Personal Appearance Occupations**
*Payroll Employees versus Self-Employed*

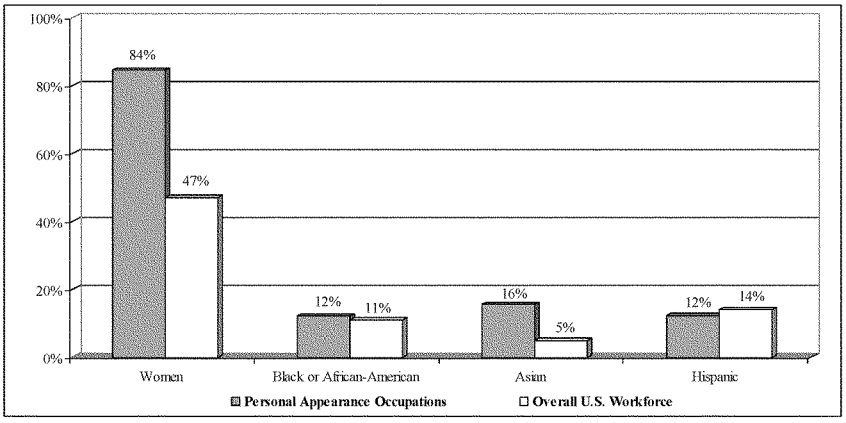



Source: U.S. Department of Labor, Bureau of Labor Statistics; 2010 data

**The Salon and Spa Industry Provides Career Opportunities for Individuals of All Backgrounds**

- The nation's salon and spa industry provides first jobs and career opportunities for individuals of all backgrounds, and has a broader representation of women and minorities than the overall U.S. workforce.
- Eighty-four percent of individuals in personal appearance occupations are women, compared to 47 percent of employed individuals in the overall U.S. workforce.
- Twelve percent of individuals in personal appearance occupations are Black or African American, compared to a national average of 11 percent.
- Sixteen percent of individuals in personal appearance occupations are Asian, compared to just five percent of the overall U.S. workforce.
- Twelve percent of individuals in personal appearance occupations are of Hispanic origin, slightly below the national average of 14 percent.

**Breakdown of Employed Individuals by Gender, Race and Ethnicity**
*Personal Appearance Occupations versus Overall U.S. Workforce*

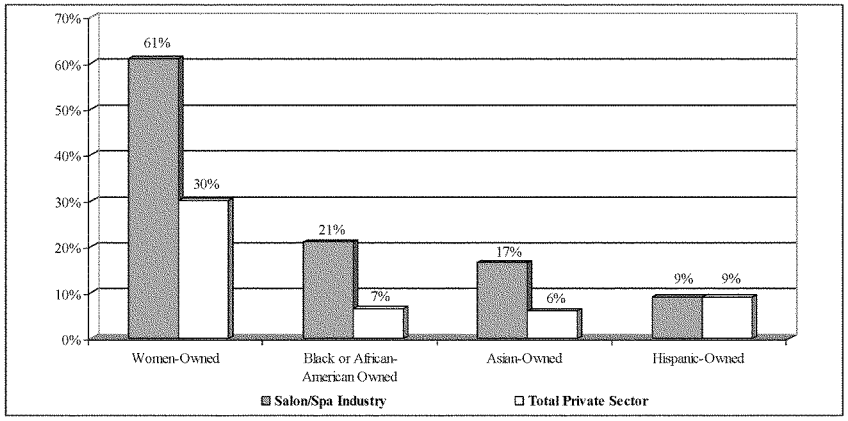



Source: Bureau of Labor Statistics; 2010 data

**The Salon and Spa Industry Provides a Path to Ownership Opportunities**

- Not only do salons and spas provide employment opportunities for individuals of all backgrounds, they also give individuals the experience to own businesses of their own.
- Sixty-one percent of salon businesses are owned by women, compared to just 30 percent of businesses in the overall private sector.
- Twenty-one percent of businesses in the salon industry are Black or African-American-owned, versus just seven percent of total private sector businesses.
- Seventeen percent of salon businesses are Asian-owned, nearly three times the six percent Asian-ownership rate for businesses in the overall private sector.
- Nine percent of salon businesses are owned by individuals of Hispanic origin, matching the proportion of Hispanic business ownership in the overall private sector.

**The Salon and Spa Industry Provides Ownership Opportunities for Women and Minorities**
*Proportion of Businesses Owned by Women and Minorities*




Source: U.S. Census Bureau; 2007 Economic Census; represents all businesses

**STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER**
**U.S. SENATE COMMITTEE ON FINANCE HEARING OF JUNE 28, 2011**
**COMPLEXITY AND THE TAX GAP: MAKING TAX COMPLIANCE**
**EASIER AND COLLECTING WHAT IS DUE**

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the complexity of the U.S. tax code and issues involving the tax gap:

Albert Einstein once said, *the hardest thing in the world to understand is the income tax.* If there is one thing that we can agree on as Republicans and Democrats, it is that Albert Einstein was a pretty smart guy. But with the Internal Revenue Code, he apparently met his match.

And things are only getting worse. Year after year, the tax code becomes more complex. This has contributed to two separate, but related, problems. First, the complexity of the code undercuts compliance. Complying with the tax code should not be a Choose Your Own Adventure story, where the complexity of the code leaves citizens guessing their tax liability. As Chief Justice John Marshall explained, *the power to tax is the power to destroy.* The power to tax is massive and intrusive. And given our constitutional commitment to personal liberty and the right to property, citizens should be well aware of what their tax liability is.

The second issue, one related to the Code's complexity, is the tax gap. The tax gap is basically the difference between the amount of money that taxpayers legally owe, and the amount that the government actually collects. The tax gap is the great white whale of deficit reduction. If only the government was able to collect what it is owed, our deficits would be reduced significantly. For the 2001 tax year the IRS estimated the tax gap to be $345 billion. Even after taking into account late payments and IRS collections, that amount was estimated to be $290 billion. While the government should be able to reduce that amount significantly, it would be a mistake to put too much deficit reduction hope into that the tax gap basket. As an empirical matter, it is impossible to completely eliminate the tax gap. For example, some taxpayers legally owe a significant amount of money, but do not have the assets or income to pay off their tax debt. As the old saying goes, you can't squeeze blood out of a turnip.

Yet, the tax gap debate has philosophical implications as well. The government could close the tax gap entirely by putting IRS agents in every family's living room and in every small business. But this is a price that a liberty loving people, and their representatives, are rightly unwilling to pay.

When it comes to compliance, I am convinced that the federal government is often its own worst enemy. As the Code becomes more complex, compliance drops, and the tax gap increases. Consider the impact of the health care law alone on the tax code. Courtesy of this law, taxpayers with Flexible Spending Accounts — accounts designed to provide user-friendly choices to patients — now need to go to their doctor to get a prescription for over the counter drugs like Prilosec.

Courtesy of this law, there is a 10 percent tax imposed if you use a tanning bed at a tanning salon, but not if you use one at your gym.

As this committee considers ways to address the tax gap, the whole ordeal over the health care law's 1099 provision provides an instructive example. In the name of reducing the tax gap, Congress and the President imposed considerable burdens on individuals and businesses, redirecting vital resources toward additional government paperwork. The burdens associated with the 1099 provision were so severe that even the provision's proponents were calling for its repeal soon after its enactment.

Outside of health care policy, we have other examples of the political and economic difficulty of addressing the tax gap. To reduce the tax gap, Congress passed a provision requiring 3 percent withholding on government contractors. But as a result of the compliance burdens that it has created, Congress has already delayed the effective date of this provision.

The matters being discussed today are ones that should inform our efforts at fundamental tax reform. As I have said before, I will be guided during that debate by the three criteria that President Reagan set out during the Tax Reform Act of 1986. President Reagan explained that tax reform should promote economic growth, fairness, and simplicity. Tax reform is a priority of this committee, and I believe that President Reagan's three criteria are equally applicable today.

The tax gap implicates President Reagan's second criteria — fairness. When some taxpayers are paying what they owe but their neighbors aren't, that is unfair to the taxpayers meeting their obligations. In effect, it increases their share of the load. Furthermore, lack of compliance undermines confidence in the tax system, in turn leading to less voluntary compliance. In short, when law abiding taxpayers think that the complexity of the code rewards creative accounting, and that some people are getting one over on the government, it will make them less likely to comply voluntarily. Since our tax system collects the vast majority of its taxes through voluntary compliance, maintaining and improving voluntary compliance is critical.

President Reagan's third criteria of tax reform — simplification — is also relevant to today's discussion. Since the Tax Reform Act of 1986 was enacted, Congress has passed over 14,000 amendments to the tax code. Fundamental portions of the tax code, such as the tax rates themselves, are set to expire at the end of 2012 unless Congress again acts to prevent a massive tax increase.

This unfortunately causes uncertainty for small business owners and others, and causes Americans to invest less and hire fewer workers than if Congress were to provide long-term assurances that their tax rates will not increase. The ever-increasing complexity of the tax code, which is only heightened by the temporary nature of many provisions, needs to be improved upon in tax reform. We need a tax system with a more streamlined set of permanent provisions that is easier to comply with and less complex.

Mr. Chairman, thank you again. I look forward to hearing the testimony of the witnesses.

**David Kirkham, President of Kirkham Motorsports**
**Testimony for the Senate Finance Committee's June 28, 2011 Hearing on "Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due."**

Mr. Chairman, Ranking Member Hatch, and Members of the Committee, I'm David Kirkham, President of Kirkham Motorsports in Provo, Utah. Kirkham Motorsports is a small business. The great majority of our customers are small business owners that I speak to every day. We all share similar concerns outlined here.

Small firms make up 99.7 percent of all employer firms and employ over half of all private sector employees in our economy. Small business is all about creating productive jobs that make all of our lives better. Our government's job in the economy is to act as a referee and not to choose sides. Our government should make sure everyone plays by the same rules. Our government should not pick winners and losers. Regrettably, both Democrats and Republicans continually introduce innumerable bills which create even further complexity in the tax code by picking winners and losers.

Myriad bills force businesses to make decisions based on tax consequences and not on what would be in the best interest of growing the business. A good example of this is when only a couple of months ago McDonalds hired 62,000 workers because they received a waiver from Obamacare. McDonalds' decision was driven by the waiver, not by its own business needs. It is difficult to grow a business (and create the need for more employees) when all financial decisions must be focused on tax consequences which change on a regular basis only further complicating matters. One of the most unnerving elements to the tax code is the fear of retroactive tax changes which can be enforced at any time.

Our complex tax system creates a very large burden on small businesses in terms of the time and money that it takes to comply with the tax laws. To deal with the tax laws, our small business has to hire a bookkeeper, an accountant, and a professional accounting firm that has both lawyers and accountants. If the tax system were simpler, we would be able to hire more workers with the money we currently use to pay lawyers and accountants. The constantly changing tax laws present an ever-moving target for small business owners. For example, no one has any idea what the tax rate will be from one year to the next. This makes long-term planning extremely difficult. For example, provisions in the code, such as the one on expensing of equipment, are changed frequently--dictating to small businesses when they should buy equipment. In some years it is more advantageous to hire more workers. In other years it is more advantageous to purchase more equipment because the business can write off the entire cost of that equipment in some years and not in others. Our business decisions should

be made based on what will cause our business to grow and create a better world for everyone and not on some tax law that has recently been changed.

Some tax laws that are simply incomprehensible--for example, the 1099 provision in ObamaCare that would have imposed a huge burden on small businesses. I surmise Congress was trying to reduce the amount of the tax gap with that provision, but Members of Congress should think about the burdens they are going to place on small businesses and the American people before they pass laws to try to reduce the tax gap. It is good that the 1099 provision was repealed, but it should never have been enacted in the first place. The tax code should be the tax code. The earned income tax credit is not tax code. Leave taxes to the tax code and let social spending stand on its own merits.

The tax gap.

I believe the vast majority of Americans understand the need to pay taxes and are willing to pay them—if they think the taxes are fair. If people feel they are being treated unfairly, they will try to avoid paying them. Waivers are a pernicious problem because they are not equally applied to all people; consequently, waivers are viewed as little more than bribes to a favored constituency. Waivers granted to special constituents are inherently unfair as they favor one group of people over another. Waivers require favors—which must be repaid. Who decides what must be repaid and from whom will it be taken? When the government loses the trust of the people, they also lose the willingness of the people to pay taxes.

If you want people to comply with the tax laws, they need to be easy and fair to comply with. If you want more revenue, I would suggest you follow the Wal-Mart model and try to gain as many customers as possible by broadening the tax base and making compliance easy so everyone has a stake in our system of government.

Finally, when you choose winners, we all become losers. History teaches us cronyism, confusion, and chaos creates recessions and depressions. Freedom creates prosperity. Let us be free to choose our own path in life and to create our own prosperity. Then, and only then, will you see the unemployment rates plummet, the tax gap shrink, and the recession finally end.

Thank you,

David

David Kirkham, President
Kirkham Motorsports

WRITTEN STATEMENT OF

NINA E. OLSON

NATIONAL TAXPAYER ADVOCATE

HEARING ON

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

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

JUNE 28, 2011

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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,[2] when 132 million tax returns were filed.[3] 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.[4] In other words, taxpayers voluntarily and timely pay about 32 times as much as the IRS collects through enforcement and voluntary late payments.[5] 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.[6] 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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[2] *See* IRS, *Tax Gap Map for Year 2001* (Feb. 2007), *available at* http://www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf.

[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.

[6] IRS, *Fiscal Year 2010 Enforcement and Service Results* (Nov. 20, 2010), http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf; Government Accountability Office (GAO), GAO-11-142, *Financial Audit: IRS's Fiscal Years 2010 and 2009 Financial Statements* 20 (Nov. 2006), http://www.irs.gov/pub/irs-utl/2010_enforcement_results.pdf.

## 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.

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

taxpayers (37 million out of 133 million) did not claim the credit.[12] 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.[13] 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.[14] 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.[15] 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.[16] About 60 percent of all individual income tax filers used paid tax return preparers in 2009.[17] Studies attempting to pinpoint the precise impact of preparers on compliance are contradictory and inconclusive.[18] However, a wide

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

[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.

[14] GAO, Ref. No. GAO-06-603, *Capital Gains Tax Gap: Requiring Brokers to Report Securities Cost Basis Would Improve Compliance if Related Challenges Are Addressed* 12 (June 2006).

[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.[19] 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.[20] 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.[21] 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

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*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 Prepares 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).

[19] GAO, GAO-06-563T, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 2 (Apr. 4, 2006) (statement of Michael Brostek, Director - Strategic Issues, Before the Committee on Finance, U.S. Senate).

[20] GAO, GAO-02-509, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (2002).

[21] TIGTA, Ref. No. 2003-40-046, *Analysis of Statistical Information for Returns with Potentially Unclaimed Additional Child Tax Credit* (2003).

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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[22] *See* Robert Kidder and Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance,* 2 Taxpayer Compliance 47, 47-72 (1989); Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 5 Kans. L. Rev. 1145 (2003).

[23] *See, e.g.*, National Taxpayer Advocate 2007 Annual Report to Congress, vol. 2, at 138-150 (Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance*) (surveying tax compliance literature); National Taxpayer Advocate 2010 Annual Report to Congress, vol. 2, at 71 (*Researching the Causes of Noncompliance: An Overview of Upcoming Studies*) (proposing research into the causes of noncompliance).

[24] *See* OECD, Forum on Tax Administration Compliance Sub-group, *Managing and Improving Tax Compliance*, 47 (Oct. 2004), http://www.oecd.org/dataoecd/44/19/33818656.pdf. *See also* Valerie Braithwaite and Jenny Job, *The Theoretical Base for The ATO Compliance Model*, Centre for Tax System Integrity — Research Note 5 (2003), http://ctsi.anu.edu.au/publications/RN5.pdf. As part of a survey of a large number of papers from various disciplines, the Swedish Tax Agency suggested the

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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model is consistent with the conclusions in these papers. Swedish Tax Agency, *Right from the Start, Research and Strategies* 8, 110-116 (Aug. 2005).

[25] *See, e.g.*, Notice 2000-44, 2000-2 C.B. 255.

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.[29] 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).[30] 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.[31] Congress ultimately passed two "fixes" intended to address the problem by accelerating AMT credits and abating certain AMT-related liabilities.[32]

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.[33]

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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.

[32] *See* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432 § 402, 120 Stat. 2922, 2953 (2006) (codified at IRC § 53(e)), *as amended by*, Tax Technical Corrections Act of 2007, Pub. L. No. 110-172 § 2, 121 Stat. 2473 (2007); Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, Division C, § 101, 122 Stat. 3765, 3863 (2008) (codified at IRC § 53(f)).

[33] *See, e.g.*, Notice 2004–28, 2004-1 C.B. 783.

### 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.[34] Similarly, when tax laws are burdensome, complicated, or ambiguous, these taxpayers may simply resolve uncertainty in their favor (*i.e.*, procedural or lazy noncompliance).[35] Some may not even know they are cheating because they do not understand the law or have difficulty with procedural requirements (*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.[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 (*e.g.*, interest and dividends) – yet less than 50 percent on income not subject to third-party information reporting.[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)

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[34] *See, e.g.*, *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).

[35] *Id.*

[36] For additional discussion of the importance of third party information reporting in prior testimony, see, *e.g.*, *The Tax Gap and Tax Shelters, Hearing Before the Senate Comm. on Finance* (July 21, 2004) (statement of Nina E. Olson, National Taxpayer Advocate); *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); *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); *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); *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).

[37] *See* IRS, *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.[38]

## IV. The Current Tax Code Imposes Excessive Compliance Burdens, and Is Filled with Special Tax Benefits and Complicated Tax Rules of General Applicability.

### 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.[39]
- 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.[40]
- 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).

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

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

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

individual taxpayer (as measured by income) rose from $220 in 2000 to $258 in 2007, an increase of 17 percent.[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 (*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:

- *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.[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.[48]

- *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.[49] While that loophole has been closed, the credit still covers the $100,000-plus Tesla sports car.[50]

- *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.[51]

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

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[46] *Id.* at 26.

[47] *See* IRC § 170(h).

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

[49] *See* IRC § 30D.

[50] IRS, *30D. New Qualified Plug-in Electric Drive Motor Vehicles - Tesla Motors Inc.*, http://www.irs.gov/businesses/article/0,,id=219921,00.html (last visited June 16, 2011).

[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.

### C. The Tax Code Is Filled with Complicated Tax Rules of General Applicability.

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,"

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[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.[59] 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.[60]

### 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.[61] 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,[62] while an S corporation tax return is not due until the 15th day of the third month after the end of the tax year.[63] 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.[64] 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.[65] These unprocessed returns accounted for nearly 17 percent and 24 percent of all new S corporation filings for those two years.[66]

*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*.[67] 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.[68]

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[64] IRC § 1362(b)(3) and (b)(5). *See* Rev. Proc. 2007-62, 2007-2 C.B. 786; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 97-48, 1997-2 C.B. 521. The IRS Office of Chief Counsel issued 226 PLRs for late S corporation elections under IRC § 1362 from FY 2007 to FY 2009, for which the IRS charged a user fee ranging from $625 to $14,000 per request. TIGTA, Ref. No. 2010-10-106, *Chief Counsel Can Take Actions to Improve the Timeliness of Private Letter Rulings and Potentially Reduce the Number Issued* (Sept. 10, 2010). For current PLR procedures and user fees, *see* Rev. Proc. 2011-1, 2011 I.R.B. 1.

[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.

[68] National Taxpayer Advocate 2010 Annual Report to Congress 278-290 (Most Serious Problem: *S Corporation Election Process Unduly Burdens Small Businesses*).

### 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[69] as well as tax treatment for both the worker and the service recipient.[70] 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.[71] 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.[72] 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;[73] (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;[74] and (4) direct the IRS to conduct

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[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.

[72] Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885-86 (Nov. 6, 1978).

[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.[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.

*Recommendation*: We have recommended that the AMT be repealed.[76]

### 6. The Family Status Provisions Are Complicated.

Notwithstanding the improvements brought about by enactment of a Uniform Definition of a Child in 2004,[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.

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

[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: *Repeal the Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2006 Annual Report to Congress 3-5 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2004 Annual Report to Congress 383-385 (Legislative Recommendation: *Alternative Minimum Tax*); National Taxpayer Advocate 2003 Annual Report to Congress 5-19 (Most Serious Problem: *Alternative Minimum Tax for Individuals*); National Taxpayer Advocate 2001 Annual Report to Congress 166-177 (Legislative Recommendation: *Alternative Minimum Tax for Individuals*); *see also Alternative Minimum Tax: Hearing Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways & Means* (March 7, 2007) (statement of Nina E. Olson, National Taxpayer Advocate); *Blowing the Cover on the Stealth Tax: Exposing the Individual AMT: Hearing Before the Subcomm. on Taxation and IRS Oversight of the Senate Comm. on Finance* (May 23, 2005) (statement of Nina E. Olson, National Taxpayer Advocate).

[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, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002).

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).[78] 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.[80] 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.[81] 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.

[79] *See* National Taxpayer Advocate 2008 Annual Report to Congress 363-369 (Legislative Recommendation: *Simplify the Family Status Provisions*); National Taxpayer Advocate 2005 Annual Report to Congress 397-406 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach*).

[80] IRC § 6013(d).

[81] *See* Edward McCaffery, *Taxing Women* (Univ. of Chicago Press, 1997).

[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.[86] 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.[87]

## 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.[88] As a result, the portion of a personal injury settlement allocable to punitive damages or awards for injury to reputation could go untaxed.[89]

In 1996, Congress addressed this perceived abuse by limiting the personal injury exclusion to apply only to compensation for physical injury or sickness.[90] This

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[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*).

[88] IRC § 104(a)(2) (1996).

[89] *See* H.R. Conf. Rep. 104-737, at 300 (1996).

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.[91] 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.[92] 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.[93] 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.[94]

### 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.[95] Before 1976, some courts

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[90] *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605, 110 Stat. 1755, 1838 (1996), *amending* IRC § 104(a)(2).

[91] *See Comm'r v. Banks*, 543 U.S. 426, 430 (2005) (holding "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee").

[92] *See* IRC §§ 56, 67, 68.

[93] *See* National Taxpayer Advocate 2009 Annual Report to Congress 351 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).

[94] *See* National Taxpayer Advocate 2002 Annual Report to Congress 160 (Legislative Recommendation: *Attorney Fees in Nonphysical Personal Injury Cases*).

[95] *See* IRC §§ 162, 262.

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.[96] In 1976, Congress revised the rules, explaining that under the "appropriate and helpful" standard:

> [e]xpenses 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.[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."[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.[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.[100] The home office deduction is also disallowed to the extent it would generate or increase a net loss for the business.[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.[102]

*Recommendation:* To reduce the complexity of the current requirements, we have recommended legislation to create an optional standard home office deduction.[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

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[96] H.R. Rep. No. 94-658, at 144-145 (1975) (citations omitted).

[97] *Id.*

[98] *Id.*

[99] *See* IRC § 280A(c)(1).

[100] *See* IRC § 280A(c)(1), (2), and (4).

[101] *See* IRC § 280A(c)(5).

[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).

[103] *See* National Taxpayer Advocate 2007 Annual Report to Congress 503 (Legislative Recommendation: *Home Office Business Deduction*).

square footage of the portion of the home used as an office.[104] 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.*[105]

### 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.[106] 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.[107] 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.[108] Some tax shelters seem so egregious and "too good to be true" that the taxpayer should be penalized regardless of the explanation.[109] 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).[110]

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?[111] 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.[112] As a result, it is more

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[108] For example, the American Jobs Creation Act of 2004 enacted new penalties under IRC §§ 6662A and 6707A to increase the standards of conduct required to avoid the imposition of understatement penalties on certain "reportable avoidance transactions" and to address failures to disclose "reportable transactions." Pub. L. No. 108-357, § 8, 811-812, 118 Stat. 1418, 1575 (2004). Congress has also revised the penalties imposed on tax return preparers, changing the standards required of tax return preparers and significantly increasing the maximum penalty amounts that can be imposed under IRC § 6694 for violations of those standards. Pub. L. No. 110-28, § 8246, 121 Stat.112, 200 (2007); Pub. L. No. 110-343, § 506, 122 Stat. 3765, 3880 (2008).

[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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Tax Section, *Report on Codification of the Economic Substance Doctrine* (Jan. 5, 2011) (same); Nathan Rhone, letter to IRS, Re: Notice 2011-39, *reprinted as*, Solar Energy Trade Association Asks How Economic Substance Doctrine Affects Investment Credit, 2011 TNT 111-43 (Jun. 9, 2011) (same); Giesselman, *A Significant Problem Defining a 'Significant Purpose' and the Significant Difficulties that Result*, 111 Tax Notes 1119 (June 5, 2006) (voicing confusion about the meaning of "a significant purpose"); Gregory M. Fowler, *The Valero Cases: New Meaning for 'Significant Purpose' Definition?,* 121 Tax Notes 677 (Nov. 10, 2008) (same).

[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.[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.[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.[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

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transaction, except that it could not be less than $5,000 for individuals or $10,000 for entities, or more than $100,000 for individuals or $200,000 for entities. *See* Creating Small Business Jobs Act of 2010, Pub. L. No. 111-240, Title II, § 2041(a), 124 Stat. 2506, 2560 (2010). For an analysis of continuing problems with the penalty, including the lack of a reasonable cause exception, see Toni Robinson and Mary Ferrari, *Congress Eases a Penalty, but Squanders Reform Opportunity*, 2011 TNT 13-7 (Jan. 17, 2011).

[115] *See* National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 24.

[116] *Hochstein v. United States*, 900 F.2d 543 (2d Cir. 1990).

[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.[118]

### 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.[119] 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.[120]

## 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.[121] 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.

[119] *See* National Taxpayer Advocate 2007 Annual Report to Congress 275 (*The Accuracy-Related Penalty in the Automated Underreporter Units*). For an in-depth analysis of the civil tax penalty regime, see National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 2 (*A Framework for Reforming the Penalty Regime*).

[120] *See* National Taxpayer Advocate 2008 Annual Report to Congress, vol. 2, at 18.

[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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[122] *See generally* Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103 (2006); Alan Berube, *The New Safety Net: How the Tax Code Helped Low-Income Working Families During the Early 2000s*, Brookings Inst. (Feb. 2006).

[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

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[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").

[126] *See* Worker, Homeownership, and Business Assistance Act of 2009, Pub. L. No. 111-92, § 11, 123 Stat. 2984, 2989 (2009), *amending* IRC § 36(d).

[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).

[128] *See* H.R. Conf. Rep. No. 105–599, at 234 (1998) (relating to e-filing goals).

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 FTBHC 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]

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[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.*

[130] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 82 (Research Study: *Running Social Programs Through the Tax System*) (citing IRS Examination Operational Automation Database (EOAD), Compliance Data Warehouse (CDW) FY 2009).

[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.[133] 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.[134]

### 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,[135] creating an incentive for low income taxpayers to work.[136] 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.[137] 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.[138] Thus, a low income taxpayer may be asked to both determine and

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[133] *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 102 n. 104 (Research Study: *Running Social Programs Through the Tax System*).

[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).

[136] *See* Stacy Dickert, Scott Houser and John Karl Scholz, *The Earned Income Tax Credit and Transfer Programs: A Study of Labor Market and Program Participation,* Tax Policy and the Economy, vol. 9, ed. James M. Poterba (MIT Press, 1995); Janet Holtzblatt, *Trade-offs Between Targeting and Simplicity: Lessons from the U.S. and British Experiences with Refundable Tax Credits* (Dept. of the Treasury, 2004) 13 (citing Dickert, Houser and Scholz among academic economists who "estimated that expansions of the EITC between 1993 and 1996 would induce more than half a million families to move from welfare to work").

[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).

[138] *See* IRS Pub. 596, *Earned Income Credit* 45 (2010).

document income, investment income, and his or her relationship to and the residency of himself or herself and one or more children.[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).[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).[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.[142]

*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.[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.[144] The worker credit could be easily verified through income reporting, leaving the more difficult family status eligibility verification to a separate family credit.[145]

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[139] In 2004, acting on National Taxpayer Advocate and Treasury proposals, Congress simplified the definition of a qualifying child, generally eliminating the need to prove the cost of supporting a child, as long as he or she is of a prescribed age, relationship, and residence. *See* National Taxpayer Advocate 2001 Annual Report to Congress 76 (Legislative Recommendation: *Family Status Issues*); Dept. of the Treasury, *Proposal for Uniform Definition of a Qualifying Child* (Apr. 2002); Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, § 201, 118 Stat. 1166, 1169 (2004). A recent proposal is by Elaine Maag, *Tax Simplification: Clarifying Work, Child, and Education Incentives*, Tax Notes (Mar. 28, 2011) 1587 (proposing uniform qualifying age of 19).

[140] *See* IRC § 152(c)(2).

[141] *See* IRC § 152(c)(1)(B).

[142] See IRS, *Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns,* at 13 (Feb. 28, 2002).

[143] *See* National Taxpayer Advocate 2008 Annual Report to Congress 363 (Legislative Recommendation*: Simplify the Family Status Provisions)*; National Taxpayer Advocate 2005 Annual Report to Congress 397 (Legislative Recommendation: *Tax Reform for Families: A Common Sense Approach)*.

[144] Similar proposals have appeared in Pres. Econ. Recovery Advisory Bd., Rep't on Tax Reform Options: *Simplification, Compliance, and Corporate Taxation* 8 (Aug. 2010), and Pres. Advisory Panel on Fed. Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System* 63 (Nov. 2005). Another proposal is by Robert Cherry and Max B. Sawicky, *Giving Tax Credit Where*

### 3. The Complexity of Delivering Special Tax Benefits May Require Appropriate Funding for the IRS Along with a Dual Mission Statement.

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.[146] 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."[147]

*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;[148] (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.[149]

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*Credit Is Due: A "Universal Unified Child Credit" that Expands the EITC and Cuts Taxes for Working Families,* Econ. Pol'y Inst. Briefing Paper, Washington, D.C. (2000).

[145] *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 75, 90 (Research Study: *Running Social Programs Through the Tax System*).

[146] *See* Patient Protection and Affordable Care Act, Pub. L. No. 111-148, § 10105(e)(1), 124 Stat. 119, 906 (2010), adding IRC § 45R.

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

[148] Rev. Proc. 64-22, 1964-1 C.B. 689.

[149] *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.[150] 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."[151] 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.[152] 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.[153]

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[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.[154] 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.[155] 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.[156] 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 (*i.e.*, data not shown on the face of the return) that is not necessarily reliable.[157] 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.[158] 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.[159] 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.

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[154] *See* National Taxpayer Advocate 2002 Annual Report to Congress 189 (Legislative Recommendation: *Math Error Authority*).

[155] *See* IRC § 25A(i).

[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)

[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.

[158] *See* IRC § 6213(g)(2)(P)(iii).

[159] *See* National Taxpayer Advocate 2002 Annual Report to Congress 185 (Legislative Recommendation: *Math Error Authority*).

*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

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[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.

[162] National Taxpayer Advocate 2009 Annual Report to Congress 17-40 (Most Serious Problem: *One-Size-Fits-All Lien Filing Policies Circumvent the Spirit of Law, Fail to Promote Future Tax Compliance and Unnecessarily Harm Taxpayers*); National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 1-18 (TAS Research Study: *The IRS's Use of Notices of Federal Tax Lien*). *See also* National Taxpayer Advocate 2009 Annual Report to Congress 357-364 (Legislative Recommendation: *Strengthen Taxpayer Protections in the Filing and Reporting of Federal Tax Liens*).

pay the outstanding tax debt.[163] In this way, it can also hamper the taxpayer's ability to pay past, present, and future tax liabilities.[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."[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.[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.[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).[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.[169] In cases where the source of a payment was coded or could be

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[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.

[164] *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).

[165] Automated Collection System (ACS) *Customer Service Activity Reports (CSAR), FY 2009 BOD report. 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).

[166] IRM 5.19.4.5.2 (May. 20, 2011); IRM 5.12.2.4.1 (Apr. 15, 2011).

[167] IRS, *IRS Data Books, Table 16, Delinquent Collection Activities, 1999 - 2010.*

[168] IRS, *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* 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.

[169] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 1-18 (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.[170] Moreover, there is no evidence that NFTL filings improve future compliance.[171]

*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.[172]

## 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.[173] At the end of FY 2010, approximately 3.3 million of these accounts,

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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 13th week of 2009.

[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.

[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).*

[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).

[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. *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

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[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).

[177] *See* National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 21-33 (*Subsequent Compliance Behavior of Delinquent Taxpayers: A Compliance Challenge for the IRS*).

[178] National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 21, 30. Similarly, at least half of the taxpayers who reported cancellation of indebtedness income (CODI) – meaning another creditor cancelled the taxpayer's debt – also appeared able to pay. National Taxpayer Advocate 2009 Annual Report to Congress, vol. 2, at 21, 30.

expiration date.[179] Moreover, the IRS only accepted approximately 95,000 installment agreements (IAs) on business-related tax delinquencies, which generally involve small business taxpayers.[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.[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.[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.[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.[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.[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.[186]

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[179] IRS, Collection Activity Report, NO-5000-108, *Monthly Report of Offer in Compromise Activity* (Oct. 2010); IRS, Collection Activity Report, NO-5000-6, *Installment Agreement Cumulative Report* (Oct. 2010).

[180] *Id.*

[181] IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Cumulative Report* (Oct. 2010).

[182] IRS, Collection Activity Report, NO-5000-C23, *Collection Workload Indicators* (Mar. 2011).

[183] IRS, Collection Activity Report, NO-5000-2, *Taxpayer Delinquent Account Reports* (Oct. 2010); IRS, Collection Activity Report, NO-5000-23, *Collection Workload Indicators* (Oct. 2010).

[184] *See* TIGTA, Ref. No. 2010-30-046, *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. *Id. See also* IRS, *Collection Process Study* 98 (Sept. 30, 2010).

[185] IRS, Media Relations Office, *IRS Announces New Effort to Help Struggling Taxpayers Get a Fresh Start; Major Changes to Lien Process*, IR-2011-20 (Feb. 24, 2011).

[186] IRS, Collection Activity Report, NO-5000-108, *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, *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).

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.[187] 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.[188] 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.[189]

## 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

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[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.

[189] 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).*

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

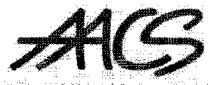
Tax simplification could go a long way toward improving compliance and reducing the tax gap. Ideally, I believe Congress should simplify the tax code through broad-based tax reform,[190] but if comprehensive reform is not imminent, I urge Congress to enact some of the many narrower simplification recommendations we have proposed over the years, many of which I have summarized in this statement.[191]

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.[192]

[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.




July 7, 2011

Senator Max Baucus
Chairman
219 Dirksen Senate Office Bldg.
Washington, DC 20510

Senator Orrin G. Hatch
Ranking Member
104 Hart Senate Office Bldg.
Washington, DC 20510

Dear Chairman Baucus and Ranking Member Hatch:

On behalf of students who enter our doors seeking rewarding careers in the professional occupations of their choosing, as well as our graduates who leave with a quality education which has prepared them for ***jobs available today*** in a $90 billion a year industry ($40 billion from small business salons and spas); the American Association of Cosmetology Schools (AACS) would like to commend the Senate Finance Committee for holding the July 28, 2011 hearing on *Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due.*

**AACS shares the Committee's concerns with the growing tax gap, and believes strongly that one way to reduce the gap, while at the same time enhancing information reporting by *all* cosmetology professionals, is through the swift enactment of Senator Olympia Snowe's "Small Business Tax Equalization and Compliance Act of 2011" (S. 974).**

Now, more than ever, it is imperative that all facets of the cosmetology industry (institutions, small business salons & spas, larger corporate and chain salons & spas, as well as manufacturers and distributors) work with Congress and the Internal Revenue Service (IRS) to ensure, to the highest degree possible, proper and accurate tax and tip reporting.

The important benefits inherent in Sen. Snowe's proposed legislation from the perspective of a small business owner were clearly articulated by Ms. Kris Carpenter, and AACS supports her testimony on behalf of the salon and spa industry.

**From an institutional perspective, the accurate collection and reporting of income (earnings) has taken on new significance as a result of recently promulgated regulations by the U.S. Department of Education.**

Under final regulations published in October 2010 and June of this year (34 CFR Section 668.6 & 668.7), federal student financial aid eligibility for vocational and occupational programs leading to gainful employment in a recognized occupation will soon be determined based upon: 1) students annual loan repayment rates; and 2) graduates ratio of student loan debt-to-earnings.

**Therefore, it is of the utmost importance to the cosmetology school industry that the taxpayer education requirements are fulfilled by each and every graduate.**

We are confident of the quality of the education and training our member schools provide and the job demand for our graduates. As highly state-regulated institutions of higher education institutions curriculum content, program course length, and students ability to enter the workforce through licensure are all determined and assessed through outside evaluation. As federally recognized institutions of higher education we comply with standards and criteria established by national accrediting agencies and the Department of Education, including a strong focus on consumer information, student outcomes, financial literacy, and taxpayer reporting requirements to the IRS.

The U.S. Department of Labor and the Bureau of Labor Statistics has labeled cosmetology-related profession as "in-demand" occupations and the U.S. Department of Labor, Occupational Outlook Handbook, 2010-2011 states –

- ✓ "Overall employment of barbers, cosmetologists, and other personal appearance workers is projected to grow much faster than the average for all occupations."
- ✓ "Personal appearance workers will grow by 20 percent from 2008 to 2018, which is much faster than the average for all occupations." and
- ✓ "Job opportunities generally should be good, particularly for licensed personal appearance workers seeking entry-level positions."

And yet, paradoxically, **the future longevity and sustainability of cosmetology schools, their education programs, and the supply of qualified professionals to meet the considerable job market demand, will be heavily based upon the strong reporting of past graduates income – employees, independent contractors, and booth renters alike.**

**In light of the newly established Department of Education regulations, AACS urges your support for swift enactment of the "Small Business Tax Equalization and Compliance Act of 2011" (S. 974).**

Sincerely,

Jim Cox
Executive Director

Christine Gordon
President

Comments for the Record

Complexity and the Tax Gap:
Making Tax Compliance Easier and Collecting What's Due

United States Senate Committee on Finance
Tuesday, June 28, 2011, 10:00 AM
215 Dirksen Senate Office Building

Submitted by:

Michael Bindner
Center for Fiscal Equity
4 Canterbury Square
Suite 302
Alexandria, Virginia 22304

Chairman Baucus and Ranking Member Hatch, thank you for this opportunity to provide comments to the Committee. We will leave it to other expert witnesses to describe how such options as the Value Added Tax (VAT) and a VAT-like Net Business Receipts Tax (NBRT) can be useful in providing incentives to accurately report taxes at every stage of the production process.

It is likely that for many, this unavoidability of payment is one of the reasons such taxes are opposed. These features are also one of the main reasons that these options are superior to the so-called Fair Tax, which will likely increase the tax gap because many items which are in fact purchased for end use will be accounted for as wholesale in order to avoid taxation. If taxes are paid at each stage of production, this problem does not exist. Of course, analysis of how VAT systems are actually implemented suggests that the VAT is no panacea in stemming tax avoidance, especially if multiple rates and loopholes are present in the system.

At the Center for Fiscal Equity, we marvel at strength of the myth that if only the Tax Gap were eliminated, all would be right with the world of federal finance. Indeed, part of the mythos behind the Fair Tax is that finally prostitutes and drug dealers would be paying their fair share of taxes under this plan.

This assertion is patently false and misunderstands the relationship between consumption taxes and income taxes. Income taxes are essentially a hidden consumption tax, especially when one is purchasing from a business with federal and state tax identification numbers. Most employees in these cases never see that portion of their earnings which go to pay Federal Income, State Income, FICA, and Hospital Insurance payroll taxes. These monies essentially go from sales or other revenues right to federal and state governments, along with any sales taxes collected.

Unless prostitutes and drug dealers obtain tax ID numbers and report taxes as businesses under a Fair Tax, a VAT or a VAT-like NBRT, their payment of such taxes as consumers will likely be no different than their current indirect payment of the income and payroll taxes of those from whom they purchase goods and services.

Waiters, bartenders and the self-employed are also no more likely to pay more under tax reforms designed to eliminate the tax gap. Rather, these reforms can best close the tax gap by simply trying to collect taxes from them if their income falls under a certain threshold. This allows the government to set appropriate rates without the expectation that better enforcement might lead to a balanced budget.

There one more issue we would like to put on the record in this debate, however: the question of who is an employee and who is an independent contractor. Waiters are often considered semi-independents, especially when tips are left in cash rather than added to the bill and paid with credit cards. In many more advanced companies, part time contractors and even essentially full time employees are hired as contractors or independent brokers, even though all of their efforts are dedicated to a single wholesaler or customer. The insurance and home cosmetic industries are prime examples of workers who are essentially employees operating and reporting as if they were independents. This is done to minimize benefits paid and to force the burden of tax reporting onto these employees, thus fueling the problem of low compliance.

Limits on revenue could be used to essentially keep these vendors outside the tax collection system. It could be called an Avon Lady exemption. In a VAT system, enacting such an exemption would lead to little tax loss, as the entire supply chain leading up to these vendors would still pay tax. This would not be the case under a Fair Tax system. Indeed, in a Fair Tax system, Congress would likely be required to consider such vendors employees of the supplying firm in order to realize all potential tax revenue from these industries.

The Center has outlined the NBRT to this Committee and its companion in the other body on more than one occasion. One of the strengths of this tax is that it can be used to preserve both the health insurance exclusion and an expanded child tax credit – and potentially could lead to a wide variety of tax expenditures designed to shift the funding of social services from the public sector to the private sector. This strength cannot be realized, however, when the sales force or consultants are considered outside vendors, nor would leaving such individuals outside the franchising company eliminate the need for them to file taxes as business owners. To the extent that ease of compliance is a goal of tax reform, reconsidering the issue of who is considered an employee must take place.

Thank you for this opportunity to provide comments to the Committee.

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July 8, 2011

The Honorable Max Baucus, Chairman
The Honorable Orrin G. Hatch, Ranking Member
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

RE: Submission for Hearing Record

Dear Senators Baucus and Hatch:

On behalf of the Professional Beauty Association (PBA), the nation's largest organization of beauty industry professionals, thank you for holding the June 28th hearing, "Complexity and the Tax Gap: Making Tax Compliance Easier and Collecting What's Due." Small business owners across the country who operate salons and spas share your concerns about the issues of tax compliance and fairness.

We very much appreciate the opportunity for Kris Carpenter, a PBA member and salon owner from Billings, Montana, to testify on this important issue and how tax compliance affects the salon industry in particular. As Ms. Carpenter mentioned in her statement, S. 974, the Small Business Tax Equalization and Compliance Act of 2011, introduced by Senators Snowe and Landrieu would have a meaningful impact on compliance for America's small businesses in the salon industry by enhancing income reporting in the salon industry through education and straightforward reporting requirements.

We are hopeful that as the Senate Finance Committee and the Senate as a whole consider how to best tackle the billions lost due to issues with tax code compliance, they will look to the solutions found in S. 974.

The Professional Beauty Association thanks you for your efforts and we look forward to working with you on an effective solution.

Sincerely,

Steve Sleeper, Executive Director

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