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COMPLEXITY OF THE INDIVIDUAL INCOME TAX

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

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FIRST SESSION

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COMPLEXITY OF THE INDIVIDUAL INCOME TAX

THURSDAY, APRIL 15, 1999

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

The hearing was convened, pursuant to notice, at 10:05 a.m., in Room SD–215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators Baucus, Breaux, Graham, Bryan, and Kerrey.

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order.

Well, it is tax day, and it is fitting that we meet to examine the complexity of the individual income tax.

More than any other day of the year, April 15th is the one associated with frustration and even anger. Over 126 million returns are to be filed by today, bringing as many Americans into the labrynth of the tax law and leaving most all of them, once they have mailed their return, feeling uncertain as to whether they are cheats or martyrs.

I have heard it said that mistakes in filing returns can be found 99.9 percent of the time when one is looking for them. In fact, last year, Money magazine sent 60 tax professionals the case of a hypothetical family, and 46 of the professionals returned the assignment and no two came back with the same bottom line. It was the seventh time in the history of the test that complexity within the code stumped the experts to the extent that every outcome was different, despite the fact that each professional was working with the exact same data.

What struck me most about the recent study was the professional's answers ranged from a tax liability of $34,000-plus to $68,900, a difference of 101 percent.

Is this surprising when Congress has passed almost 80 tax bills in the last 13 years that have made changes in the Tax Code? In the Taxpayer Relief Act of 1997, Congress added 85 new sections to the code and amended another 824. Since then, another nine bills that included tax provisions have been passed into law, and today, the code stands at 5.5 million words, requiring some 17,000 pages.

We all know why the code has become so complex, revenue-raisers buried deep inside the law into ideological differences that end up being split in half at the eleventh hour, the concerns of competing interests. These are only a few of the reasons.

What we need to examine today is just how complex the code is, how it affects Americans and their families, and how can we go about simplifying the system. This is our objective, simplicity and fairness.

Just take a look at the summary of phase-out prepared by the Joint Tax Committee staff. They are listed over there to the right. If you want a prime example of complexity, this is it. Most of the phase-outs differ. There is little uniformity. Most importantly, all the interaction between the phase-outs and qualification for the various provisions cause chaos for taxpayers and the IRS.

We must also examine, among other things, the threat of alternative minimum tax run amuck. The AMT was originally passed to bring about fairness, to make certain that everybody was sharing in the burden of paying for Government.

Unfortunately, the exemptions, the threshold phase-outs, and the breakpoint amounts were never indexed for inflation. The result is that the number of individual taxpayers subject to the minimum tax is rapidly increasing, threatening middle-class Americans and large families. We need to look at this. Not only is the AMT hitting individuals and families it was never intended for, not only is the AMT calculation complicated, but countless taxpayers must suffer through the calculations to determine that they do not even owe the tax. This must change.

Of course, fixing the AMT and in fact any meaningful tax simplification carries revenue loss, but this must not deter us in our objective. We need to explore ways within the budget rules that make the code simpler and fairer. It will not be easy, but it is necessary.

In order to fix the AMT and provide meaningful simplification to the taxpayer, this committee needs the resources through a net tax cut.

I look forward to hearing testimony from our witnesses today. I appreciate the time that Val Oveson, our National Taxpayer Advocate, has taken to be with us.

There is no question that if we are to succeed in replacing complexity with simplicity, the Congress and the IRS must work together. After all, we are here to serve the same people.*

Mr. Oveson, please proceed.

STATEMENT OF W. VAL OVESON, NATIONAL TAXPAYER ADVOCATE, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. OVESON. Thank you. Thank you, Mr. Chairman and distinguished members of the committee. I am pleased to make my first appearance before this distinguished committee.

As I have said in my 1998 annual report to Congress, I hope all of you have a copy of that. I have other copies with me here today. I believe that my role is to be the voice of the taxpayer and to be

* For further information on this subject *see also* "Overview of Present Law and Issues Relating to Individual Income Taxes," Joint Committee on Taxation staff report, April 14, 1999 (JCX-18-99).

an advocate of a more equitable, balanced approach to tax administration.

I am working hard each day to do just that. It is a challenging and difficult assignment and work, but the reward to me as I go home each night is to be able to solve a taxpayer's problem and make a difference with individual taxpayers.

I would like to thank you, Mr. Chairman, and the members of the committee on behalf of the American taxpayers for the increased protections that you provided as part of the IRS Reform and Restructuring Act of 1998. I have witnessed firsthand the benefit that provisions of this new legislation have provided to taxpayers, and I am looking forward to seeing many more be helped in the coming years.

I would like to thank you for inviting me to address the subject of complexity on this appropriate day. Complexity of the tax laws is the number one problem facing taxpayers.

I made this statement in my annual report and used as a reference surveys from several groups, including individual and small business owners, tax practitioners, and taxpayer advocates that work for me now in the field.

This is an important day not only because it is the tax-filing deadline, but also because you recognize, as you have just stated in your opening remarks, that there is a need for simplification of the tax laws.

I have always felt that complexity is much like the weather. Everybody talks about it, but nobody does anything about it, and I am here to be one of those everybodies talking about sources of complexity in the tax law and I hope that this Congress will be the somebody to do something about it.

I congratulate again Congress for trying to get a handle on complexity as demonstrated by the Section 4022 of RRA 98, which calls for complexity studies to be conducted by the IRS and the Joint Taxation Committee.

I am confident that these two studies mandated by law will identify specific sources of complexity. The Commissioner study will provide empirical data on how existing tax laws affect taxpayers. The study by the Joint Committee on Taxation will estimate a complexity index for legislation and how it affects taxpayers.

I believe that both the frequency and the number of tax law changes presents the most serious complexity concern. In 1986, Congress dramatically changed the laws by enacting the Tax Reform Act of 1986. The goal was to create a simpler, fairer, and more efficient tax system. In that act, Congress made approximately 1,850 separate amendments to the code. It reduced the number of tax brackets, simplified the standard deduction, and made other changes that greatly reduce the complexity.

Since 1986 and ending with 1988, Congress made approximately 6,500 changes to Title 26 in 61 different pieces of legislation. In fact, the Taxpayer Relief Act of 1997 and RRA 98 alone made 1,260 changes to the code, Mr. Chairman, as you alluded to in your statement.

The magnitude of the changes made by those two pieces of legislation resulted in revisions to at least 100 separate IRS forms. This translates into additional burden for taxpayers in several significant ways.

First, it is difficult for taxpayers to understand why the law changes so much. Frequent changes promotes uncertainty and leads to cynicism and unintentional non-compliance.

Second, programming the changes into the brittle and obsolete computer systems of the IRS is expensive and fraught with risks.

Third, the magnitude of the changes makes it hard for the IRS to convey those changes effectively to taxpayers. The nature of the changes can be difficult for the IRS to explain in their forms and publications, and the frequency of the change means that IRS public guidance is reactive to the most pressing issues, such as the next filing season, resulting in fewer resources to address the long-standing issues where guidance is yet to be issued.

Finally, such frequent changes make it difficult for the IRS to train adequately the employees in the work force.

For example, the TRA 97 changes of the law regarding capital gains, it lowered the rates, provided different rate bases on the type of investment property and length of the holding periods. It resulted in the IRS completely overhauling the Schedule D and a marked increase in the amount and time of information required to complete the form.

While this is an extreme example of additional complexity, imagine this multiplied by 1,260 times over the last 2 years. Cumulatively, over the past 13 years, the changes over the last 13 years have greatly increased the complexity of the code.

In conjunction with the complexity studies, I hope that you will choose to simplify the code. If not, then I hope that you will reduce the complexity and its detrimental effects on taxpayers and the tax system by not changing the Tax Code so frequently.

While the frequency in number of changes of the tax law adds a great deal of complexity, it is obviously not the only factor. Beyond those changes, I believe that the targeted relief and incentives for groups of taxpayers significantly adds to the complexity of the tax law and the difficulty that the taxpayers have at understanding and complying with the law.

I would like to point out, before I go further, that I am not commenting on the merits of the policy reasons for targeted relief. Those of you in positions to make policy decisions may conclude that a certain subsidy is best delivered through the Tax Code. My goal here, like the RRA 98 studies that you have mandated in the law, is to point out to you where the laws cause concerns for taxpayers and make complications.

Recently, the administration and the Congress enacted many new laws, giving many credits to help families, such as the child tax credit, the adoption credit, and the education credits. These are in addition to the already-existing credit, such as the child independent care credit. While these credits have resulted in lower taxes for the taxpayer, they have also increased the complications these same taxpayers experience in filling out the returns and in dealing with the IRS.

Most of these credits sound like they involve similar concepts, but the tax laws define them differently. For example, the definition of qualifying child and qualifying individual used to determine eligibility to claim the various credits is different in almost every case of the individual credits. So taxpayers who sit down to prepare their returns must fill out the different worksheets and schedules and look to different instructions each time they claim a similar-sounding credit to determine if they are eligible under the definitions that apply.

Further, the interaction of these targeted provisions with each other and with other currently existing provision creates a great deal of complexity. The credit mentioned above must be claimed in a specific order.

In addition, the various credits are each subject to their own individual income phase-outs. These phase-outs are equivalent to marginal rate increases and require a taxpayer to perform additional calculations on a separate worksheet rather than simply entering the standard credit amount on the form.

The combination of these credits, along with exemptions and deductions, can also cause unintended consequences and major difficulty for taxpayers as they become subject to the alternative minimum tax that you have mentioned.

Again, I am not proposing what you should or should not employ or that you should or should not employ targeted relief or incentives. Rather, I am suggesting that this type of legislation increases the complexity of the tax law. You must weigh the desire for simplicity against the policy reasons for the legislation.

I understand that the next panel will raise some very specific issues that could reduce complexity, and in the limited time that I have available to me, I would like to just point out a couple of other areas that I think you could pay attention to, to create simplicity.

While the subject of AMT is popular in tax circles, the AMT itself is not. Taxpayers that were never intended to be subject to AMT are and will increasingly be subject to it in the future. They will have to calculate their taxes twice, once in the standard rules and then the other one under the AMT rules. Taxpayers must understand the basics of the two systems.ms.

I believe that the penalty and interest systems are unnecessarily complex, and as a result, misunderstood by taxpayers. I am confident that the RRA 98 studies that are required on the penalty and interest schemes will provide you with a road map for improving this tool of tax administration in helping it be more simplified and more easier to use.

Mr. Chairman, there is no more appropriate day than today to discuss our tax laws and the effects of those laws on the citizens of this country. It is my hope that you will take up the difficult task of reducing complexity of the code, and if not, I recommend that you do not add to the complexity and that you slow down the frequency of the change in the tax laws.

Thank you, Mr. Chairman and members of the committee, and I would be happy to answer questions.

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

The CHAIRMAN. Thank you, Mr. Oveson.

As the Taxpayer Advocate, you make an annual report, which contains various legislative proposals. What are your top legislative proposals to address particular tax law complexity facing taxpayers?

Mr. OVESON. Well, today, in the context of the complexity of the code, again, I am going to point to five items that I have just dealt with in my testimony.

Number one is the frequency and number of changes, and I realize that that may not look like a tax proposal because it is kind of an anti-tax proposal, but that would be my number-one suggestion, to reduce the frequency and the amount of the change.

Number two is the differential in the definitions of the credits and the phase-outs and the difficulties there, AMT, penalties and interest. Many of the 38 suggestions that I have made to Congress in my annual report cross-walk to those five items, and even though I have listed complexity as the number-one problem of the 20 problems facing taxpayers, the 38 suggestions that I have made in the annual report all do not deal directly with complexity. Indirectly, I think they do, but there are issues there for the earned income tax credit simplification.

There are issues there dealing with depreciation and depreciation rules, with the residential rental property, some of the difficult rules there where I have made individual suggestions, but the direct answer to your question, Mr. Chairman, is the five items which I have just listed, which are the mega issue and the complexity equation.

The CHAIRMAN. Do you have any data on the complexity caused by the various phase-outs in the code? What would you do about those?

Mr. OVESON. I do not have any specific data about the phase-outs, and I take from your question, we have nearly 300,000 cases last year that we dealt with in the Advocates office, and we are very careful about coding those cases with their major issue codes. We do not have a major issue code for phase-outs, for example. That is something that we need to look at as we redo the report, which I am in the process of doing. The format and the content of the report to get to you next year is being redone, and I would like to work with you and your staff to make sure that we have some agreed-upon major issue codes that get you the information that you need, but right now I do not have information that would specifically relate to the phase-outs.

I know intrinsically and intuitively that it is causing a great problem with taxpayers, and as I talk with practitioners and others around the country, I know it is a concern, but it is not reflected in the annual report as such.

The CHAIRMAN. What about the interaction between the various credits? Do you have any comment on that?

Mr. OVESON. Only the comments that I have just made in terms of the interaction of those credits. Again, I have got a spreadsheet here I could show you, showing the individual components of all of the credits that are there and how different each of the components are and how complicated it is to work through the worksheets and the spreadsheets.

I will make a supposition to you that many of the cases that are reflected in our case work coming up through our Advocates, though they may not be coded with those credits, certainly involve the frustration of filling that out.

With earned income tax credit, I know that is the case, and about 10 percent of those cases do involve earned income tax credit in some way. It is very difficult for the people that qualify that to fight their way through the procedures, to claim it, and then fighting their way through the administrative procedures we have in the IRS to make sure that they claim it is also a challenge.

I have mentioned that and made suggestions in my annual report. In fact, there are several recommendations on earned income tax credit in the report.

The CHAIRMAN. As you have mentioned, you are relatively new to your position of National Taxpayer Advocate. You took it over, I guess, what, last September?

Mr. OVESON. September, yes, sir.

The CHAIRMAN. How would you describe your first 7 months on the job? Have there been any surprises?

Mr. OVESON. Yes, there have been surprises. I was prepared for the tax administration rough-and-tumble, if you will, because I have been involved with that first-line basis for several years, but the intensity of the work has been somewhat of a surprise to me, and the intensity of those cases coming up through the system, many of which reach my desk. And I am dealing with individual taxpayers on a daily basis, working to resolve their problems, to analyze their situations, and I am accustomed to that from my prior experiences.

The CHAIRMAN. What is your background?

Mr. OVESON. I spent 5 years as the chairman of the Utah State Tax Commission which is the revenue department in the State government, involved with State tax administration nationally with several groups. I am a CPA by background and have been in private practice earlier in my career.

The CHAIRMAN. Based on your experience with taxpayers, do you believe taxpayers would forego benefits as a tradeoff for simplification?

Mr. OVESON. That is a question I think you will have to answer in the bigger context.

I believe that simplification is a major issue to taxpayers, and I believe that, again, going back to the case work, the frustration that taxpayers have with the system, whether they are able to point to it, specifically to the Tax Code or the administration of the system, I think it is difficult for them.

The CHAIRMAN. Senator Bryan?

Senator BRYAN. Thank you very much, Mr. Chairman, for convening this hearing on a day that has special significance for all of us, and congratulations to you, Mr. Oveson, on your first appearance before the committee.

I do not think a single member of the Congress or a single person in America would deny the fundamental thesis of your appearance here this morning. This Tax Code is extraordinarily complex and has become more complex with the passage of each year.

Many members of Congress who are either CPAs or lawyers would dane themselves to prepare their own tax return because of its complexity.

Much criticism is directed at the Internal Revenue Service, and I think the chairman's hearings of last year and the year before—some of that criticism, I think is appropriately directed. Nevertheless, as you indicate in your prepared remarks that the Taxpayer Relief of 97 and the RRA of 98, both pieces of legislation which I supported, made 1,260 changes in the Tax Code. If you include the 1986 changes, which predated my arrival here in the Congress, 6,500 changes.

Each of those changes had a constituency, an advocacy group, and with respect to those advocacy groups, each of those changes, I suspect those groups would say the Congress did a good thing.

The distinguished Senator from Florida and I were commenting just a moment ago in terms of what the answer to the chairman's question might be, would taxpayers be prepared to forego some of the tax benefits for simplicity, and the Senator from Florida with his usual insight responded, I think, appropriately. If you are a beneficiary of the tax change, the answer would be no. If you were not, the answer would be yes. I think that is probably true.

My question really leads into what we can do to address this situation. You will recall in the development of the legislation which bears H.R. 2676, that testimony was brought before us that indeed these changes are enormously complicated and complex, and sometimes in our zeal to pass legislation, which we believe accomplishes a desirable objective—and I might just add parenthetically, in general, the American public pays less in the way of Federal income taxes today than it did a decade ago. So, in a broad sense, some of these changes have had very significant, in my judgment, positive benefits, but it was suggested that the Internal Revenue Service itself needs to work more closely with the Congress, and I think in that sense, the Congress needs to work more closely with the Service in terms of drafting, in terms of the timing of implementation because so frequently we will make these changes, as you know, and we do not even give the Service enough time to develop the necessary regulation or the manuals for implementation.

I would welcome your insight in terms of how that process might be improved upon, or is that an avenue which might lead to a more simplified Tax Code or a less complexity or less difficulty when we make these changes in terms of the taxpayer who has the burden of filling out all of this paperwork?

Mr. OVESON. I think there is room for improvement in discussions and communication between the Congress and the IRS and the Treasury regarding complexity and the changes to the code.

I assume, again, my position and the parts of the code that created my position and the reporting relationship that I have with Congress was geared to direct part of that very question, a direct conduit from really the inside bowels of the IRS with these cases that we are having problems with, boiling up to the top so that you can see the issues that are involved in those particular cases, so that you can know what they are and choose or not choose to do something about them.

The issue of complexity, that we have a stronger commitment to reduce that complexity and to make the simplifications, or do we have a stronger tendency to accomplish some of the other policy objectives, I think that is the question. Again, only you can answer that.

Senator BRYAN. Everybody embraces the complex of simplicity. Nobody would argue in this committee or any other committee in the Congress, it would be a desirable thing to make the Tax Code more complex. Nobody argues for that.

Oftentimes, to achieve the objective of some tax policy, we create these complications, not to make things more difficult, but to achieve what we believe to be a desirable result.

I guess my question to you is, from what you observe, is there within the Internal Revenue Service—I mean, they work with the code every single day. Fortunately, for most of us, we have that unhappy experience as we file our annual or our quarterly returns only. It is not a day-to-day experience. Is there a sense that in working with the Code that recommendations can be made to the Congress to simplify certain features of the code without changing the underlying policy which the Congress has embraced? Is there such a mechanism? Do you see any focus within the Service to do that?

Mr. OVESON. Yes. Again, my role in my report, also in RRA 98, you have mandated a study by the Commissioner of the IRS dealing with complexity, and your own tax-writing committees will also be doing the same for you. I think you have set up a mechanism that will give you much better information going into the future regarding complexity than you have had in the past, a much better focus on complexity.

Again, what you choose to do with that information is a policy decision that you will have to make in conjunction with the administration, but you will have better information at your fingertips, and I look forward to participating very directly with the Commissioner in the formation and the development of that study that he is required to do by RRA 98.

So I think there is some hope and some mechanism there to make that happen.

Senator BRYAN. My time is up, but if I could just, Mr. Chairman, ask one last question.

In this Congress, there are literally dozens of proposals to change the Tax Code, dozens of proposals. Any indication that the sponsors or supporters of that legislation have worked with the Internal Revenue Service, not that obviously a member of Congress needs to get concurrence with the Service, but to talk with them and say look, this is what I would like to do, is there some way that we can draft this to achieve my goal, but not unnecessarily add complexity to the code? Do you see any of that kind of dialogue or colloquy occurring at all?

Mr. OVESON. I have not seen much of that dialogue, although it may have happened and I am not aware of it, but we certainly could get further information.

Senator BRYAN. I thank you, Mr. Oveson.

I thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bryan.

Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

I would like to build on the questions that you were asking and those that Senator Bryan has just asked relative to an approach to tax simplification.

It seems to me that we have some good examples in other areas of legislation that might be illustrative of how we could approach the tax question.

One of them was in the tax reform itself, but not in the code, but rather in the administration of the code.

It was 3 or 4 years ago, the Congress passed a statute that set up a commission to look at the issue of IRS administration of the Tax Code. That commission made its report, and last year Congress passed probably the most substantive reform of the IRS procedures in recent history.

That approach, which says let's break the problem down into its constituent parts, and in this case, the part being the administration of the code, let's have some thoughtful people look at that component of the problem and develop recommendations with some constituency for the adoption of those recommendations, and then submit that report to Congress, Congress held hearings, identified those areas of the report that it felt were worthy, and adopted some 70 or 80 specific recommendations relative to IRS administrative reform.

That process is not unlike what we do in many committees as it relates to the reauthorization process. Last Congress, for instance, had the reauthorization of the Surface Transportation Act, one of the largest in terms of dollar amount and most complex of the Federal-State relationship programs that we have, and once every 5 or 6 years, we reauthorize that program.

In the interim, we pretty much have adopted a discipline of hands-off. So we are not constantly changing the basic laws that relate to surface transportation, except in those designated years when we will specifically focus attention for purposes of reauthorization.

With those couple of examples of what I think have been successful approaches, that avoided the number-one criticism that you have made, and that is that we intend to want to change the Tax Code at least once a year, if not more frequently.

Your thoughts about adopting almost a reauthorization approach to the various components of the Tax Code—and my approach would be maybe adopting the new IRS structure, which breaks the Tax Code down based on categories of taxpayers—there is going to be a small business unit. There is going to be sort of a large taxpayer unit. There is going to be a non-governmental organization unit. Possibly, that might be the format for periodic relooks at the Tax Code; that is, every 5 years that we would look at each of those components of the Code, with a systematic external review prior to that relook, and then we would exercise the discipline that we would not look at that part of the code until the next 5- or 6-year cycle.

I wonder if you could comment as to whether an approach like that might deal with your fundamental criticism to frequent changes in the code, and provide a road map for periodic review of the code that would avoid it becoming stultified by inattention.

Mr. OVESON. Certainly, taking on the whole code at once, with complexity, as the chairman has mentioned, the number of pages and the number of words and all of that, without breaking it down into some kind of a component would make sense, and the code certainly does fit into certain categories in terms of partnerships and corporations and individual income tax. Indeed, as you mentioned, that is the modernization of the IRS, and the vision of Commissioner Rossotti is following that pattern.

So, certainly, there is some room for breaking that down into component parts to address it, and I would be happy to work with you on further pursuing those individually with you, and also the Restructuring Commission, that kind of a mechanism with outside individuals involved certainly has worked well in the past, and I am sure it could in the future.

Senator GRAHAM. Mr. Chairman, I appreciate those remarks, and I accept your generous offer of working further on those. I would like to ask if we can include in the record of this hearing a very thoughtful op-ed piece that appeared in today's Washington Post by Robert Samuelson. He sort of decried what he thought was the death of the interest in tax simplification and what the consequences of that burial would be.

I would hope that we would not be calling in the undertaker for tax simplification, but some creative fresh approaches, pragmatically, how to actually make it happen.

The CHAIRMAN. Without objection, the op-ed will be included.

[The information appears in the appendix.]

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Oveson, to what degree is our system more complicated than that of other countries? I am trying to get a voluntary compliance and the degree to which other countries' systems are as complicated or less complicated or more complicated.

Mr. OVESON. Senator, I was wanting to go back to the other direction to talk about State tax systems. I notice two former Governors here in the room, and with you, the Revenue Director of Montana, who is a very good friend of mine, and the comments you made yesterday with the STAWRS program.

I am not an international tax expert, and any comments that I made relative to other country systems, I am not sure would be meaningful or appropriate right now.

I have been very involved in the last 3 years with VAT tax systems and the transactional tax systems as they relate to State tax systems, as I have worked on electronic commerce issues that may be near and dear to many of your hearts with the Internet Tax Freedom Act that you passed last fall. I think our system there is probably more complicated than the other European countries.

Senator BAUCUS. What about the use of the internet and computer software? Is it possible that there will be a lot more electronic filing and that even though the code is as complex and this trend may encourage Congress, be even less discipline than it is and add even more complexities, and the code, to the taxpayer, to him- or herself, work it through the electronic filing and new software systems that may be less complex?

Mr. OVESON. The electronic filing is the hope of the future. It is a marvelous advent.

The use of electronic filing this year has increased dramatically, and I expect that in all of the IRS——

Senator BAUCUS. Does that help address the complexity problem?

Mr. OVESON. Certainly, to a degree, it does. You are deferring that complexity to experts in the artificial intelligence somewhat. I am not sure that it eliminates the problem, but it certainly defers it to others and makes it easier to handle.

I have used tax software to prepare my own return for the last several years, and I tried to use several different versions of it. Being a CPA and a tax practitioner, I play with this stuff a lot, but I filed electronically through Turbo Tax this year and paid my 995, and it was slick as a whistle. It was really neat.

Senator BAUCUS. Can we get to the point where the IRS is then distributing software, have computer programmers here, of course, instead of tax experts?

Mr. OVESON. That is being broached, and the electronic filing people are dealing with those private companies to make sure that is worked out appropriately and that we deal appropriately with that as we move into the future, but I think your comment is right on track and that it is one of the issues in this equation of complexity to address it.

Senator BAUCUS. Is anybody looking at this——

Mr. OVESON. Oh, yes.

Senator BAUCUS [continuing]. From the point of view of complexity and trying to address the complexity problem?

Mr. OVESON. We are looking at it, and again, RRA 98 gave some very specific guidelines for where we want to be in the future with electronic filing and a major impetus to making sure that we get there. That has borne fruit already, I believe, and will continue to do so in the future.

Senator BAUCUS. It just seems to me that the development of electronic commerce, too, that that could dovetail into it; that is, the tax systems with e-commerce.

What are the major changes that Congress makes that caused the greatest complexity? Is the capital gains rate, separate rate for capital gains? What are one or two of the big areas?

Mr. OVESON. The conflicting credits where you have definitions of those credits that are different and the phase-out kinds of issues, I think those are the ones that cause the most concern and the most difficulty, not only with the taxpayers—and that is certainly our primary focus and needs to be our primary focus, but with the IRS and the computer systems that we have talked ad nauseam about and the ability of the IRS to actually implement the law to train our employees and to communicate effectively with the taxpayers and to provide the service that we all want to provide becomes more difficult and extremely difficult as we get the number of changes and the complexity of those changes, particularly with areas like the credits and the phase-outs.

Senator BAUCUS. Is this new provision we passed last year going to help in addressing complexity?

Mr. OVESON. Oh, yes.

Senator BAUCUS. Are you sure it is going to help?

Mr. OVESON. It has the potential of helping.

Senator BAUCUS. Why do you think so?

Mr. OVESON. You will have better information at your fingertips as you make policy decisions relative to complexity versus some policy objective that may go against complexity.

I think you will have, both from the IRS-mandated study and from the Joint Taxation Committee study, mechanisms at your hands that you have not had in the past to make those decisions.

Senator BAUCUS. I have a hunch that when the economy is doing better, people are less worried about complexity. When the economy is doing more poorly, then they are more worried about complexity. Anyway, it is a difficult problem.

Thank you very much.

I thank the chairman.

The CHAIRMAN. Thank you.

Let me ask you this, Mr. Oveson. If I understood you, you said that you used different software systems to calculate your income tax. Did the different systems come out with the same answer?

Mr. OVESON. Not always, and that is one of the reasons that I play around with it.

On my own return, which is not that complicated, I have not seen any major differences. I have seen some minor ones.

By the way, yesterday, as I was preparing for this hearing and beefing up on my understanding of the alternative minimum tax, I have studied that in school and prepared returns in the past, but being prepared for any question that you might ask me, I wondered if this tax software had picked up the AMT on my own return. I ran home last night and recalculated it manually and through the system again, and I was okay. It was a big relief.

The CHAIRMAN. You did not have to call on your own services.

Mr. OVESON. I did not have to file an amended return, which I thought I might have to do.

Senator BAUCUS. Mr. Chairman, if I might add, I have had the same experience. I have tried Turbo Tax, not with the exact same results, but close. I must say, Mr. Chairman, so far, I do not have full confidence in the software. Maybe it is because I am a little conservative about this stuff. So I had my preparer do it all, but it was pretty close.

Thank you.

Senator BRYAN. Mr. Chairman, I might just point out——

The CHAIRMAN. Yes. Senator Bryan?

Senator BRYAN. —this alternative minimum tax that was pointed out, I was just looking at the tables. That has a far broader reach with each passing year, as you know.

The CHAIRMAN. That is right.

Senator BRYAN. Back in 1987, 140,000 returns were subject to it. This year, it is 823,000. We are going to go to a million by 2009, if we make no change. Over 9 million individual income tax returns will be subject to its effect. That is something we do need to take a look at in a substantive way.

The CHAIRMAN. There is no question that that is a most serious problem, applying to many people. It was never intended to.

Senator Breaux is on his way, and I know he wants to ask some questions.

Senator BRYAN. One other question.

The CHAIRMAN. Yes, please do.

Senator BRYAN. Mr. Oveson, I have seen the number, and you may have testified. How many pages are in our Tax Code today? Do you happen to know right off?

Mr. OVESON. I am relying on the chairman's opening comments, 17,000 pages, 5 million words.

Senator BRYAN. 17,000 pages, 5 million words.

How many pages in the IRS regs? Do you happen to know?

Mr. OVESON. I do not know, but we can get that information to you.

Senator BRYAN. You can provide that.

Mr. OVESON. We will provide it to you. A lot more.

Senator BRYAN. A lot more, yes.

Mr. OVESON. Then, if you include the IRM with that, the Internal Revenue Manual, then you start to really get a big number up there as well.

Senator BRYAN. Then, you have taken on an entire forest, haven't you?

Mr. OVESON. Yes. Thank goodness for CD-ROM.

Senator BRYAN. I noticed the distinguished member from Louisiana joins us. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman, and thank you for having this hearing once again.

Thank you, Mr. Oveson, for still being here. I was the ranking member on another subcommittee, and I apologize.

One of the concerns that we had in setting up the Taxpayer Advocate was to really ensure that the Advocate was on the side of the taxpayer in the sense of representing the taxpayer to the IRS and not the IRS to the taxpayer. There was a real concern about independence and being able to really sort of separate and take off the IRS hat and put on a Taxpayer Advocate hat and do so independently and feeling free of being supervised or scrutinized by the Internal Revenue Service.

Can you give me some comment about how things are working? Give me an honest answer. Do you need a little bit more independence, or is it working sufficiently? Do you feel that you can carry out your job without fear of any kind of consequences, adverse from the Treasury Department itself?

Mr. OVESON. As was mentioned earlier before you arrived, I have only been on the job for 6½ months, and so far, the support that I have received from Commissioner Rossotti, who I report to in the Treasury Department, budget-wise and in every other way has been phenomenal. I am very comfortable with that support.

Senator BREAUX. Is he giving you a pretty clear indication to just go out and do your job?

Mr. OVESON. He has.

Particularly, the budget issues in terms of reorganizing the staff, I am in the midst of doing that, and in fact have announced 2 weeks ago or last week that we are going to be competing all of the positions in the Advocate's office. You may be hearing from your individual Advocates in Las Vegas and others who are not happy with that decision. They will be eligible to reapply for those positions, but we have changed the position description. They now have much more managerial responsibility. Heretofore, they were program managers, and I am in the midst of making those decisions throughout the country which will strengthen the independent role of the Advocate from the functions of the IRS.

I am getting tremendous support with that reorganization and with the budget issues that come along with it.

Senator BREAUX. I take it, your people will be physically located within the Internal Revenue Service offices in the various districts?

Mr. OVESON. Yes, but let's talk for a moment about the independence issue.

I get asked on a regular basis, "Since you are independent from the IRS, why are you located at 1111 Constitution Avenue and you are across the hall from the Commissioner?" I explain that I am independent within the IRS. I am not independent from the IRS.

You went through some of the mental gymnastics exercises and the passages of RRA 98, and you had differing views and conclusions. You came up with a conclusion that you did.

Being too far away from the IRS? I think in many respects, it reduces the effectiveness of the Advocate because we are not close enough to really influence the day-to-day decisions and operations.

While being too close and being under too close of supervision would be negative. So there is a balance that needs to be drawn here, and I think we need to play out the current law and to see how it works as we develop it, as we get the new organization in place.

I would very much like to stay in touch with you, all of you members of the Oversight Committee, on this issue to make sure that where you expect us to be, where the public expects us to be, and that we are not missing the mark.

Senator BREAUX. It sounds like you are getting off to a good start, but if you have any concerns, I think it is really incumbent upon you to let us know about them so that we can exercise proper oversight, but we wish you well. There is an awful lot of people in this country that are looking upon your office and division within the Treasury Department as something that gives them a great deal of hope and restores the trust of the whole Department of the Treasury and the Internal Revenue Service in particular. So good luck.

Mr. OVESON. Thank you.

Senator BREAUX. Thank you.

The CHAIRMAN. Just let me underscore the importance to which I think all of us attach to the independence of your position, and that is both a matter of organization and, of course, a matter of personal relationship.

In the past, there have been situations where the Advocate has really represented the agency more than the public, and that is something that we will not tolerate.

So we will be following very carefully your activities and would like you to come periodically and report how the job is developing, but in the meantime, we congratulate you on what you are doing.

Mr. OVESON. Thank you. I would be delighted to do that, and I thank you for the invitation to do that. I think it is important with some of the ambiguities with this position that we have very good communication with the committee and make sure that we continue to have a dialogue.

The CHAIRMAN. I think it is very important that the public and the agency understands the importance that this committee attaches to your independence.

Thank you very much for being with us. We appreciate it, and we look forward to working with you.

Mr. OVESON. Thank you.

Senator GRAHAM. Mr. Chairman?

The CHAIRMAN. Yes.

Senator GRAHAM. Before Mr. Oveson leaves, I would like to also recognize his Deputy, Henry Lamar. I worked closely with Mr. Lamar when he was the director of the North Florida IRS office. He was very helpful last year during the IRS reform hearings, giving many good ideas and then immediately implementing many of the changes that we enacted.

So, if the quality of Mr. Oveson's decisions are representative by his selection of his Deputy, I am very confident.

The CHAIRMAN. Would the Deputy please rise?

It is a pleasure to have you here today. We look forward to working with you.

Mr. OVESON. Thank you, Senator, for that oversight. I should have introduced him before, but I appreciate your confidence.

The CHAIRMAN. We will now call forward the second panel, which includes the following tax practitioners: Ms. Kathy T. Burlison, who is a Tax Research and Training Associate at H&R Block; Mr. David A. Lifson, who is the chair of the Tax Executive Committee of the American Institute of CPAs; Mr. Gregory H. Steinbis, who is president of the National Association of Enrolled Agents; and Mr. William J. Wilkins, who is the Director of the External Relations for the Section of Taxation of the American Bar Association.

Mr. Wilkins, of course, was a former staff member of the Finance Committee, having served as staff director and chief counsel from 1987–1988.

It is a pleasure to welcome you here, and we would be pleased to start with your testimony.

Let me say to all of you, your full statements will be included in the record, and we would ask you to keep your opening remarks to 5 minutes.

Ms. Burlison?

STATEMENT OF KATHY T. BURLISON, TAX RESEARCH AND TRAINING ASSOCIATE, H&R BLOCK, INC., KANSAS CITY, MO

Ms. BURLISON. Good morning. I am Kathy Burlison. I would like to thank you for the opportunity. I appreciate the opportunity to discuss tax complexity with this group.

To introduce myself, first, I would like to say that my comments are my own views. They may or may not be representative of the views of H&R Block as an organization.

This 1999 is my 16th tax season as a tax professional, and over those many tax seasons, I have seen, I have written, I have reviewed thousands of tax returns, and I bring with me today a unique perspective.

Certainly, it is a perspective that is not unique, that of a taxpayer, but in addition, I work at H&R Block's world headquarters, writing, developing, and delivering the training materials that are presented to thousands of tax preparers every year.

In addition, I work on the team that provides 10 simplification suggestions to Congress each year, and I was very pleased to see many of those suggestions incorporated in Mr. Oveson's annual report this year.

To keep my finger in the trenches, I do continue to prepare tax returns. I am an enrolled agent, and I prepare tax returns at one of our premium offices each year.

My full text and material is more technical than what I will be discussing today. I want to try and give you a flavor of what I see as a tax professional, working in the trenches, and talking with the people, with the tax preparers, and with the clients that I work with, but I do have three main points.

First, taxes are complex. There is no doubt about it. They do have a burden on taxpayers, and that burden is growing. However, that burden affects not all taxpayers equally. It is not as burdensome for some as it is for others.

Second, complexity is a needed part of our tax system.

Third, though, given that complexity, there are things we can do even within the current system that will simplify what taxpayers have to deal with, reducing the burden of complying with that complexity, while at the same time not shifting the burden of tax among different income groups.

So, first, to address the issue of complexity, it is important to put it into perspective. Most of the complexity in the Tax Code is faced by the upper-income taxpayers. The higher your income, the more likely that you are to be burdened by complexity, and these are taxpayers who frequently have complex financial lives. So the complexity of their taxes is properly reflecting their complex financial lives.

However, that burden is growing. It is starting to work its say downward within the tax system and affecting people who do not have such complex lives.

We see this in a number of ways. Some of the top areas adding to the burden, we recently asked some of our tax preparers what are they hearing from the trenches, from the clients, what is it that is most complicated, most confusing, and the answer surprised me a little until I reflected on it. And that is the whole area of education.

When I stepped back to think about it, if you look within the code, there are at least 10 separate provisions that provide benefits for taxpayers seeking higher education. Five of those benefits are new from 1997. So there is a tremendous amount of confusion as to what applies to whom and how to best take advantage of those benefits that are available.

Certainly, the American public wants choice, but this may not be the best way to give them choice. They are not well integrated. So it is very confusing.

The second area that provides a great deal of complexity is the area of IRAs. When I started preparing tax returns in 1984, I essentially had to ask two questions to determine if someone was going to have an IRA deduction, did you have earned income and did you make a contribution. That was it. It went on the tax return, and there was a benefit.

In 1987, the number of questions I had to ask became much greater, and with the new IRAs that offer a tremendous benefit for savings for retirement—The Washington Post published a chart that in fine print is this big, trying to show how the new IRA rules, including the Roth and the traditional IRAs, all interact, and it is a lot for people to have to learn.

They are still stuck back on, gee, I cannot deduct my IRA and are not quite sure how the new Roth IRA affects them, is it a good thing, is it a bad thing. They are kind of waiting to see.

The issue of change has been brought up several times already this morning, and perhaps people are waiting to see how much more change there is going to be before they decide which way to go.

Other areas of complexity, child tax, just calculating the child tax, and simply calculating the amount of capital gains tax someone owes. However, to put that again into perspective, 40 percent of taxpayers roughly can use a 1040A or a 1040EZ. It is not terribly complicated for them.

Why, then, do these taxpayers go to a tax professional in large numbers? Complexity may simply be part of the issue. It is also for convenience. It is more convenient for them to have someone else worry about what is it that I have that affects me, what are the benefits for me. It may be fear of do I know how to read all of these forms, all of these instructions, and it may simply be getting another perspective.

Because we all have to do our tax returns once a year, it allows each of us the opportunity to look at what is my financial situation, is it different from last year. It kind of forces us to look at the numbers that we might not otherwise want to, and going to a tax professional gives a hand of someone else to help you look at that and put it into perspective.

The code is complex for a variety of reasons, many of them properly in the area of Congress, in tax policy and economic policy.

With that, I will go ahead and wrap up my remarks, and just reiterate some of what Mr. Oveson has said, two areas for simplification, simplifying definitions. We have the same term meaning many different things throughout the code, and slowing down the process of change. 6,000 changes over the last 12 years comes out to nearly 1½ changes per day. It is a lot to remember.

Thank you.

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

The CHAIRMAN. Thank you, Mr. Burlison.

Mr. Lifson?

STATEMENT OF DAVID A. LIFSON, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE CERTIFIED PUBLIC ACCOUNTANTS, NEW YORK, NY

Mr. LIFSON. Mr. Chairman and members of this distinguished committee, my name is David Lifson, and I speak to you representing over 330,000 certified public accountants as the chair of the Tax Executive Committee of the American Institute of CPAs.

Our membership includes all types of tax experts, in public practice units, ranging from one person to mid-size to global professional service firms. Other members serve the tax system as tax directors in industry, tax educators, or Government employees. Our members help millions of taxpayers comply with the tax laws not just on April 15, but on a year-round basis.

These days, the process of obeying the tax law is more daunting than ever. Today's outcry for a tax simplification is not new. My simplification button is over 10-years old. We see great promise in Congress' current activities in the tax simplification arena, and we hope that the promise will lead to results soon.

Our tax law has recently grown so dense that it may undermine voluntary compliance. Complexity has already led to a growing perception by taxpayers that the tax law is unfair, increased costs in funding the IRS, increased taxpayer compliance cost, and undue interference with business formation and decision-making.

Our tradition of voluntary tax compliance and self-assessment is a national treasure. By and large, our citizens obey the law, but it is only human to disobey the law if you do not or cannot understand the rules.

The AICPA issued a blueprint for tax simplification in 1992 identifying the basic principles necessary to create a simpler tax system. That blueprint was largely incorporated into the tax law as part of the IRS Restructuring and Reform Act of 1998. Now that the framework for analyzing complexity has been established, we hope that we will have the opportunity to work with Congress to analyze current and future tax legislation. We would also welcome the opportunity to streamline the current Internal Revenue Code.

Our written submission offers insight into 10 areas that require serious revision to eliminate unnecessary complexity. There are in fact hundreds of areas that could be improved. Because of their importance, I will briefly mention three areas of particular interest today.

The alternative minimum tax is one of the most complex parts of the tax system. It was originally enacted to affect a relatively small group of taxpayers. AMT has created hardship and complexity for many new taxpayers who have not used preferences to lower their taxes, but have been caught up in these systems' outdated attempt to bring fairness. The dynamics of income have changed. So should the tax laws.

Many taxpayers who do not see themselves as wealthy believe they are being punished unfairly. At the very least, they are being confused unfairly. The enactment of several new tax credits included in the 1997 act makes the problem even worse. The AICPA and the ABA have both offered similar suggested fixes. We sincerely hope you will consider them.

The earned income credit has long been identified as an area in great need of simplification. The rules are so complex that the group of taxpayers who are intended to benefit is not always effectively able to claim their benefits.

The new dependent child care credits in the 1997 act makes this whole area of what I call family credits even more complicated.

Rather than introduce a new form, a new set of calculations, and a new set of income phase-outs, it would be far simpler to just increase the dependency exemption for children under 17.

Since exemptions already phase out for the wealthy, this would be a near-equivalent, much simpler, targeted benefit.

Phase-outs should also be simplified. There is currently no consistency among these phase-outs in either the level of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Instead of the approximately 20 different current phase-out ranges and the additional phase-outs proposed in the targeted credits of the administration's current tax proposals, we recommend three at levels representing low-, middle-, and high-income taxpayers.

There is a good bit more detail in our written statement both on the items I have mentioned here and a number of other areas. We ask that you review that statement carefully. The AICPA thanks you for the opportunity to help. We want to simplify the system for everybody's benefit.

Thank you.

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

The CHAIRMAN. Thank you.

Mr. Steinbis?

STATEMENT OF GREGORY H. STEINBIS, PRESIDENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS, MORGAN HILL, CA

Mr. STEINBIS. Good morning, Mr. Chairman, members, and staff and guests. My name is Gregory Steinbis. I am an enrolled agent and a certified public account and engage in practice in Morgan Hill, CA, which is a suburb of San Jose, commonly known as Silicon Valley.

I have been an enrolled agent in practice for over 14 years now, with scores of individuals and small businesses, and I help them throughout the year.

As President of the National Association of Enrolled Agents, I am pleased to have this opportunity to present the testimony on behalf of NAEA's enrolled agents, of all whom are practitioners, and many of them are small businesspersons themselves.

We have the opportunity through our internet service—we have been doing surveys, and so we were able to survey our members before this testimony. During the surveys, our members reported that they had an increase of business of 10, 20, and 30 percent because of the complexity.

Many taxpayers have tried to complete their own tax returns, but have found that the instructions or the law itself is so complex that it is very hard and unclear how to fill out the forms.

One of our members responded and said a young woman who made $11,500 on a W–2 and $3,000 in 1099SE income, or self-employed income, thought she could file a 1040EZ form because the form did not have complete instructions and was not clear.

When she took in to this enrolled agent to have it reviewed, the enrolled agent had to amend the 1040EZ, and explain to her why it was wrong, the fact that she had more tax due, and had to pay them a fee. As he points out, at $14,500 in income, share barely has enough money to put food on the table, let alone pay somebody to help her understand the tax law.

During this tax season, NAEA had an opportunity to have their 800 number referral line printed in a letter to Ann Landers. After that number was published, NAEA's referral line received so many phone calls that it crashed the system. A lot of people needed help.

Even after a month later, we were still receiving over 200 phone calls a day from taxpayers asking for assistance.

One of the many items that makes filing tax returns complex as a preparer is we must prepare four tax calculations. One is the regular Federal tax. One is the Federal alt-min tax, our State regular tax, and State alt-min. The complexity that we are all talking about does have interplay with our State agencies as well, and that does cause the problem.

Items that you have already heard so far about the phase-outs, we as practitioners need a work sheet at our table, like your chart that is behind us here. We need it summarized for ourselves because we cannot keep up with the software changes. We do not even know if the software is right. We have to do a manual check now and then. So all the phase-outs are here for me, as well as my fellow practitioners.

To give you an idea somehow of these affected people out there in the tax world, you take a young couple that just graduated from college. As two single people, they get their interest deduction, their education loan interest, but if they marry and because they make $32,000 each, which is a small salary, they would start losing their interest deduction because of the phase-out, and that is an everyday person. It does not take long to start to phase out.

You take another couple who make $55,000 each. They still get to keep the child credit, the new one, but they do not get any lifetime or hope credit if they have an older child that is going off to college or just even junior college because that now has been phased out.

I have a gentleman who just retired. He is 65 years old. One of the benefits that his company offered him was incentive stock options, ISOs, and because he was retiring, he was going to lose that option. So he exercised. Now he has alt-min, and today he is writing a $60,000 check to the United States Treasury and a $10,000 check to the State of California on income he has not received yet. He may receive it in the future if he outlives the stock.

As we go forward, it is not going to get simpler. These phase-outs are still here for the future, but also come this year, the IRS has ruled that our mileage for automobiles has been decreased. For the first part of the month, it is 32.5 cents a mile, for the first 3 months, and then effective April 1st, it is 31 cents a mile. That also adds to the confusion. Then, what adds to the anxiety of the taxpayers in California, gasoline just went up 34 cents a gallon in one week. So 31 cents a mile is not even going to cover the gas increase. So those add to the anxiety as well.

There are many more examples I can give you on taxpayers and their problems, but for ease of time, I want to thank you for your time. Thank you.

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

The CHAIRMAN. We would be delighted to have you provide those for the record.

Mr. STEINBIS. Okay. (See page 63.)

The CHAIRMAN. Mr. Wilkins?

STATEMENT OF WILLIAM J. WILKINS, DIRECTOR OF EXTERNAL RELATIONS, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION, WASHINGTON, DC

Mr. WILKINS. Thank you, Mr. Chairman.

The CHAIRMAN. We want to welcome you here.

Mr. WILKINS. Thank you for the welcome. I appreciate it, and it is good to be here speaking on behalf of the legal profession in the tax area.

I want to emphasize some of the basic points in our written testimony. First, we urge that the problems of individual tax complexity not be made worse.

Second, we believe that repeal of the individual alternative minimum tax should be a tax simplification priority.

Third, we would like to join the fellow panelists in focussing your attention on the problems created by phase-outs.

Finally, we commend to you and to your staffs the partial menu of particular simplification suggestions that we include in our written testimony.

On the subject of new tax laws, preventing new complexity is the greatest contribution you can make to tax simplification. We have particular concern of the pace and volume of changes affecting individual taxpayers. We have become concerned over the willingness and ability of taxpayers to comply, if they become convinced that the tax law is destined for new layers of complexity year in and year out.

The chair of the Section of Taxation recently sent a letter to Treasury Secretary Rubin expressing the section's disappointment that the President's budget proposes to add several new tax credits to the code. We do understand that each credit taken in isolation accomplishes a worthwhile purpose and adds only a small amount of complexity. We also understand that a taxpayer who gets the benefit is happy to endure the complexity in order to get the benefit.

However, we feel that that kind of microbalancing inevitably leads to a tax system that is in total overly complex and undeserving of public respect.

Simplification starts with not making things worse. It requires leadership. It requires saying no to attractive ideas, and it requires constant attention. Simplification will simply not be achieved if the administration and the tax-writing committees relegate it to a third priority or a fourth priority or a fifth priority. We urge you to make simplification a bedrock principle and to communicate that principle to all who seek this committee's help in changing the tax laws.

In reporting the IRS modernization legislation, you have imposed a complexity analysis requirement on yourselves. The Section of Taxation strongly supports this important procedural reform. We urge you to take advantage of it, to use it to develop simpler ways to achieve your legislative goals, and to remind yourselves that sometimes you need to trade off a part of a legislative goal in order to gain simplification.

On the subject of the individual alternative minimum tax, you have already heard that the AMT is a parallel system where you have to do your taxes over again. It promises to entangle millions of new moderate income taxpayers in the next decade. However, the problem is not that the AMT needs re-targeting. The problem is that the AMT adds enormous complexity and capriciousness, without accomplishing any meaningful purpose at this point. We really do urge you to think in terms of repeal.

My written testimony provides further analysis and sets forth our policy recommendations in order of preference. Our first preference, as I say, is repeal. There are other alternatives that are detailed in the written testimony.

On the subject of phase-outs, we hope that the administration and the Congress will begin to pay more attention to the negative aspects of phase-outs of tax benefits. The proliferation of phase-outs in recent years is an extremely troubling development from a complexity standpoint. This is a trend that should be reversed and in our view never should have gotten started in the first place.

Let me point out that at the recommendation of the Section of Taxation, the full American Bar Association, representing the legal profession of the United States, has adopted the position that the personal exemption and itemized deductions phase-outs be repealed and replaced with explicit marginal rate increases.

The section's submission to the ABA cited several reasons for our recommendation. The most prominent reason was that this complex hidden tax effect of the phase-out really should be replaced with a simple and transparent tax effect in the rate tables.

Finally, the ending pages of our written testimony represent the preliminary work of a task force of tax lawyers in the Section of Taxation that is developing recommendations to simplify existing code provisions.

These recommendations represent an exercise in balancing whether a provision is really worth the complexity involved, especially where there are multiple provisions operating in the same area. We believe that these recommendations could form the basis of a truly beneficial tax simplification bill, and we commend them to you.

Thank you very much.

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

The CHAIRMAN. Thank you, Mr. Wilkins.

Let me ask the panel this question. What role have regulations played in either complicating or simplifying the code? Could more be done by the regulatory agency in simplifying?

Mr. Wilkins, would you have any comment?

Mr. WILKINS. From our standpoint, our constituency and the tax lawyers generally look forward to regulations providing needed clarification, and if anything, we are often clamoring for regulations to be published rather than for them to be withdrawn.

The CHAIRMAN. Do they simplify or complicate?

Mr. WILKINS. In terms of knowing what the rules are and knowing how the IRS is going to view the nuances of the rules, I think they are simplifying. They can be quite complex, but I do think that the Treasury Department and the Internal Revenue Service have progressed in terms of adopting a style of regulation that is less highly articulated and is more a statement of goals and principles and providing lots more examples of real-life situations of how the rules apply, and I think they have become somewhat easier to use over the years. It is a lot of text, but for a practitioner, they are really absolutely critical.

The CHAIRMAN. What you are really saying is clarifying.

Mr. WILKINS. That is right.

Mr. LIFSON. Regulations are particularly helpful, and especially, I would agree, with the new style of regulations, you have to understand their practical implementation, such as can a basic revenue agent and a CPA or attorney or enrolled agent sit down together, find a regulation that answers some question that has been raised, and deal with the taxpayer's situation fairly.

The CHAIRMAN. Any further comment?

Ms. BURLISON. I would agree with what has been said that the regulations are essential to understanding what is in the code. We anxiously await the regulations.

The CHAIRMAN. I guess my real question—I realize it clarifies, but in clarifying, does it simplify or complicate?

Mr. STEINBIS. Generally simplify because it makes it clearer. So we now both are on the same page and understand what it is that is trying to be accomplished.

The CHAIRMAN. Mr. Wilkins, I think in your written testimony, you suggested exempting taxpayers with an average of less than $200,000 in adjusted gross income from AMT.

My question is, would using an average further complicate the tax law? Would this flat amount be the same for single, married, head-of-household taxpayers?

Mr. WILKINS. We would support adjusting breakpoints for the married, filing jointly, single situation. I think attention needs to be paid on that.

I think our written testimony also suggests that even though we support this as a second priority, it still would not solve all the problems, and even if that were included, there are a couple of really chronic problems in the AMT that we would like fixed in addition to that.

The CHAIRMAN. Any comments from the rest of the panel?

Ms. BURLISON. I think his comment perhaps gets to one of the issues between fairness and complexity. Wanting to have separate breakpoints for different filing statuses would be an issue of fairness, but now you have got several different definitions of breakpoints because of filing status, and that in itself does add complexity.

The CHAIRMAN. ABA recommends repeal of the phase-out of itemized deductions and personal exemption. Instead they favor a rate increase. I have to tell you, I am opposed to rate increases. I think we should be cutting them.

How would your typical client respond to a rate increase tied with the elimination of phase-outs? What do you think?

Ms. BURLISON. The clients that I deal with that have phase-outs are aware of those phase-outs, and they are not happy with them.

You are simply replacing a loss of a benefit or an increase in tax with another way of doing it, and perhaps by making it more visible, it might make it worse, simply because it is more visible, but it might make it more honest.

The CHAIRMAN. I agree with that. I think that is true.

Mr. WILKINS. I think the answer from the typical client will largely turn on what the bottom-line effect is on their pocketbook. If it is a tax increase, they will probably object to it.

On the other hand, I think that taxpayers, when they realize that the Congress, rather than putting an explicit approximate 1-percent marginal rate increase on them, has forced them to turn to the back of the tax book and do a 14-line adjustment to take away some of their itemized deductions for something that really could have been right there in the rate table, I think they are justifiably angry at that, and they suspect that somebody has done something sneaky.

I think that is a comment worth making, and that is really the point of the recommendation.

The CHAIRMAN. Somebody mentioned the complexity associated with the Roth IRA. I believe it is frankly very important that taxpayers save for the future.

I have introduced legislation to remove the complexity for IRAs by removing the caps and the phase-outs to give it universality. What are your views on this sort of simplification?

Ms. Burlison?

Ms. BURLISON. Certainly, removing the income phase-outs, the caps, makes it much easier for taxpayers to deal with making a decision as to whether they are going to contribute to convert to a Roth IRA. They do not have to worry about whether they are going to be kicked out of something that they have decided to do.

There is some inherent complexity that is going to remain for taxpayers who convert from a traditional to a Roth IRA. The calculations to determine what is taxable and when it is taxable is not easy, and that will not be addressed by eliminating the caps and the phase-outs.

Mr. STEINBIS. I do think you are going to find more people who will convert because right now I saw a lot of people who wanted to convert, but because of the $100,000 threshold, they could not. So I think you are going to find more people who are going to want to convert.

Mr. WILKINS. I also think eliminating phase-outs improves the effectiveness of an incentive, if that is what you are trying to deliver, because people can predict, people understand that they are going to be entitled to the benefit, and it is not a question of, well, maybe I will and maybe I will not.

Mr. STEINBIS. You talked about regulations. I had clients wait because we did not have the regulations. So we did not know if you funded in the Roth IRA and then found out in the middle of the year you could not and were we going to be allowed to roll back, and then, of course, the regulations came out and said we could.

The CHAIRMAN. Good.

Mr. STEINBIS. But we had to wait for those regulations, which go to the complexity of the issue of waiting to find out.

The CHAIRMAN. Let me ask you this about the educational IRA. Taxpayers cannot make a contribution to a so-called educational IRA after December 31st. Does that make any sense? Should the taxpayer be able to contribute after the end of the year, as they can in other types of IRAs?

Mr. STEINBIS. Sure, they should.

The IRA is the only one that you cannot contribute after April 15th. SEPs, you can. I think all the IRAs should be allowed to be extended to the extension date until their uniformity because that adds to the confusion.

The CHAIRMAN. Senator Bryan?

Senator BRYAN. Thank you very much, Mr. Chairman, for the very interesting panel that you have invited. Thank you very much.

Let me begin with you, Ms. Burlison, if I can. I thought you made a very clear point, and that is that taxpayers who have large amounts of income that are involved in a great deal of sophisticated investments, that they have in effect very complex financial lives, and therefore, their tax returns are going to be complicated as a result of that. I suspect that there is probably not much that we can do or should do in that area.

I would like to ask each of you what we might be able to do in terms of individuals. I think an example was cited that the individual who has a student interest loan issue can no longer use the short form, which is a simpler method of filing a return.

Give me your thoughts in terms of what we could do for that middle-income taxpayer who is now thrust into a more complicated filing system. Tele-filing, for example, has been very, very popular. It has a number of limitations. I do not know all of them.

We are told that electronic filing is increasing dramatically. Are there things that we can do without doing violence to the progressive nature of the Tax Code to make it possible for greater numbers of people to get into these simpler filing mechanisms? None of which am I suggesting reject your premise that education IRAs, child tax, capital gains, as well as the earned income tax credit and the AMTs have made life more complicated, but I am trying to think of those folks who may be able to tele-file that cannot or to simplify the tax return for those whose income is admittedly the $14,000-a-year example. I think it was Mr. Steinbis.

Let me throw that one out to each of you and see if you have any suggestion, generally.

Ms. BURLISON. Thank you.

To build on the idea of financially complex lives, more Americans are finding their lives more financially complex as they invest in mutual funds, as one simple example, and frequently, that one investment in mutual funds is going to create an inability to use a simple tax return because the mutual funds will spin off capital gains that now require a Schedule D calculation.

Simply making that calculation optional, the taxpayer could choose to take advantage of the lower tax rates, or if it is more important for them that they have a simple tax return, just use the regular rates that include the income on the front of the tax return would provide an option for simplification.

Senator BRYAN. Okay. That is helpful.

Mr. Lifson?

Mr. LIFSON. I think it is appropriate, especially on April 15th, to consider filing a simplification, but I think that that is really the tip of the ice berg.

The deeper problem is figuring out what number to put on the form or what number to enter into the computer, not how to get the number from your computer or your piece of paper to the IRS.

Your phase-out, our simplification proposal, and some of the other speakers have commented similarly, would certainly greatly reduce the amount of effort that people in middle- and lower-income brackets would have to go through to figure out what number goes on the piece of paper, what they qualify for, and how to organize their financial lives in a way where they can be encouraged to save and encouraged to build on their own futures.

Senator BRYAN. Mr. Steinbis?

Mr. STEINBIS. We are talking about the current complexity, but the complexity was started in 1986. We do have the computers to help us, and that has made life easier or complicated. I am not sure how you want to look at it, but one of the examples I have in mind is the gentleman who is an engineer, pretty knowledgeable, understanding. He can read code, and he can read and understand computers. He does his own tax return using Turbo Tax.

He has a rental property, and he finds the line that says interest deduction, and he has a 1098 from the bank that says he paid $10,000 of interest on his rental property. He puts it on the rental schedule and finds out that he does not get a deduction because his salary is over $150,000.

So, being smart, he reads on and he puts it on the Schedule A as a second home. So it is more the understanding of where it goes on the form and why it goes on the form than the idea of ways of filing because that is a real-life situation.

Senator BRYAN. Mr. Wilkins?

Mr. WILKINS. If I could offer the observation that the income tax is necessarily complex for complex personal financial situations, it does not at all need to be complex for a return of a wage-earner with interest income from the bank.

Senator BRYAN. That is my point.

Mr. WILKINS. It would in theory be possible to have a return-free filing system for people in that category in fact, and I urge you to remember that when you are thinking about individual tax complexity that, yes, the income tax return is complex for people that have to spend money to make money, but for people who make their money from working and investing in at the bank, the income tax system is really just a tax on gross income. It can be quite simple.

Senator BRYAN. Thank you, Mr. Chairman.

The CHAIRMAN. The number is changing, isn't it? More and more people are having complicated financial situations by investing in mutual funds and so forth.

Mr. WILKINS. The mutual fund example is very appropriate.

The CHAIRMAN. That is true, but it is changing. It is changing rapidly.

Mr. WILKINS. That is true, and it is also true as more people have retirement funds that they are managing themselves as opposed to having fixed pensions from their employers.

The CHAIRMAN. Senator Graham?

Senator GRAHAM. Thank you, Mr. Chairman.

One of the areas of complexity in the Tax Code are the number of provisions that have been inserted over the years to achieve certain social or economic goals.

One of my concerns is that it is said that the most indestructible institution in America is a Congressional subcommittee. If that is true, I would say the second most indestructible is a provision that is one that is inserted in the Internal Revenue Code.

Any suggestions of a systemic process by which those provisions might be periodically subjected to a performance analysis, i.e., was the goal that originally led to this provision being added to the code in fact accomplished over time, and does that provision warrant, justify continuation based on its social contribution in comparison to its revenue consequence?

Mr. WILKINS. If I can try that one, I think there is a balancing act here in that you do want to achieve certainty and predictability to some point, but I also think that you might look at a kind of triage where you go first to areas where there are multiple provisions addressing the same policy goal, and seeing if you cannot really weed your garden a little bit.

The example about provisions affecting families with children is really an excellent example. Another excellent example is the overlapping provisions dealing with tax sheltering for individuals. There is a real question whether after the enactment of the passive loss rules, some of the additional things that address the same area are really necessary anymore, and to the extent they do anything are the things they do worth doing in exchange for the complexity.

I would urge you to look at that kind of a choice of areas to look at.

Mr. LIFSON. There are other areas, too. Worker classification comes immediately to mind where the changing landscape of the way people work and the emergence of people's practical ability to tele-commute, work at home, and still contribute to a single business organization bring about horrendous decision-making problems in terms of worker classification as to whether you are an employee, an independent contractor.

It is particularly difficult for start-up businesses that often rely on the large group of workers that are available only part time at their convenience and not under the direct supervision of an employer, many second workers and many women and many people who prefer and can afford to not live in a traditional brick-wall world. Electrons are holding us together and going to be holding us together a lot more in the very near future, and the tax law has to think about how it is going to start treating people that way. We still have a very bricks-and-mortar attitude about how we tax our business organizations. I think that needs some addressing.

Mr. STEINBIS. My example of the woman who made $11,500 on a W–2 and $3,000 on a 1099 self-employed income, obviously the employer or the employing person thought she was independent, and she thought she made earnings. So, back to his comment about worker classification, that is very important.

Mr. WILKINS. There is a really perverse interaction of the alternative minimum tax with the worker classification issue that is mentioned in our testimony, but there have been published cases where individuals have lost the independent contractor/employee fight in court, and the result has been that because of the alternative minimum tax, they have essentially been taxed on their gross income, even though that can be 50, 60, 100, 200 percent of their net income, and that is just a perverse result that ought not to happen.

Senator GRAHAM. Let me ask another question. The situation that we are facing, trying to deal with the complexity of a Tax Code is not unique to the United States or not unique within the United States to the Federal Government. Are there any entities that you believe have done an effective job of trying to avoid or mitigate complexity within their Tax Code?

For instance, someone has suggested to me, today, that Australia has had a system of weeding out complexity. That is all I know about that. Are there any role models that you would suggest we ought to look at?

Mr. STEINBIS. I do not do any international tax. So I really cannot answer that directly, but, indirectly, the National Association of Enrolled Agents has been visited by the Korean tax authorities and the Japanese tax authorities because they think our system is somewhat fair versus their systems or the other systems which have been unfair. So I can only relate it back that way.

Mr. LIFSON. I believe the studies show that we have the highest rate of compliance and the easiest collection system where most of our taxes are collected, some 98 percent, voluntarily rather than through enforcement actions.

Our concern is that our system, which is the envy of the world, may become crippled by its current state and needs improvement to maintain its first-class status.

Senator GRAHAM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Breaux?

Senator BREAUX. Thank you, Mr. Chairman.

I thank all the panel members.

I would observe, it seems to me, considering who you all represent, that the more complicated we make the Tax Code, the better off all of you do. I always tell some of my folks back home, who are CPAs, quit complaining about how complex it is. The more complex we make it, the better you all do.

I was intrigued by that article in the Post this morning by Robert Samuelson. I am not sure how many of you read it, but I may ask for your comments because it really talked about the complexity of the Tax Code.

Mr. Chairman, he was bipartisan in his criticism. He said the Clinton administration, often with the help of Republicans, has returned us to a tax system that is increasingly an instrument of social engineering, economic tinkering, partisan favoritism and propaganda. The Tax Code is being crammed with special-interest provisions, intended mainly to advertise public solidarity, with some selected constituency social group or cause. It points out a number of examples.

The Clinton administration wanted to endear itself to parents of college students. So it advocated we pass the very complex system of tax breaks for college tuition. Now it wants to flaunt its compassion for families caring for their older parents, with the $1,000 long-term care credit, proposes an array of new credits, including a $2,000 credit for buying a highly energy-efficient new house.

Then it goes on, Mr. Chairman, and like I said, he is bipartisan in his criticism. He says the Republicans do not do much better. He said they are fare up fairly hypocritical because Republicans also plug targeted tax credits, and mentioned our Roth IRA proposal as doing this and then Clinton stole——

The CHAIRMAN. He is wrong there.

[Laughter.]

Senator BREAUX. One exemption there.

Then he says Clinton stole the Roth IRA idea for his long-term care credit from the Republicans. It really says that while many times we all give lip service to making the Tax Code fairer and flatter and more simple and everything else, but then at the same time, we all rush off to do targeted special interest tax breaks for every possible constituency that is out there.

So I guess my point is to lay this out and ask for your comments on this. One of them was called in 1986, tax change is one of the best things we ever did for its simplicity, but every year since then, we have just made it more complicated and fill it with special-interest tax breaks.

Any comments on that?

Ms. BURLISON. If I may put some perspective on that, I have had the opportunity over the last month to visit H&R Block offices across the country, and I have done this in the past where I have visited. You get a sense of an office when you walk in.

One of the surprising things is the marked lack of hostility toward the tax system this year.

Senator BREAUX. That is because everybody is doing so well.

Ms. BURLISON. Everyone is doing so well, and you are right, there is added complexity and there is targeted groups and there are individuals who are frustrated or upset that they do not get a benefit, but, by and large, the complexity gives people benefits, not everybody, but if I have got an added complexity to my tax return, I ma getting some benefit from it, versus 1986 which flattened the rates, took a lot of complexities eventually out of the tax system, but in 1987 through 1990, we had significant added complexity because of the phase-out of all of those things. So we had unhappy clients who were coming to us and saying, "Why is my return more difficult? Why is it costing more to have my return done? And I have lost some of my benefits."

So, in the eyes of the average taxpayer, while complexity is not good, if there is such a good thing as good complexity, it is going to be the item that gives them some benefit.

Senator BREAUX. Aren't most of the people by a large majority still filing the basic simple form and not itemizing?

Ms. BURLISON. Right. Over 40 percent are filing a non-itemized return, and that number has been down because of 1986. It is much fewer people filing itemized deduction because of the changes of 1986, but it took us 5 years of phase-out to get to that point because of the transition rules.

Senator BREAUX. Do any of the others have any comments about the general thrust of Samuelson's article?

Mr. LIFSON. It is clear to me that when complexity leads to higher tax, then the complexity can undermine the system because you are putting a great deal of burden on people to go out and be very clever about how to charge themselves more tax in a self-assessment system.

On the other hand, when the complexity leads to some form of benefit, then people are less likely to be upset to spend a little money to get something.

Senator BREAUX. Most people say, "Look, it is more complex, but it is worth the complexity because I am getting something from it."

Mr. LIFSON. When the complexity leads to a benefit, that is right. It becomes somewhat more tolerable.

Mr. WILKINS. Mr. Breaux, if I could offer the view, I think the editorial was right on point, and it was making many of our points, with a little more flair, I think, in the writing than the tax lawyers can manage, but I would say that it is true that someone has to be the steward of what simplicity there remains in the Tax Code.

These proposals will always be with us. Somebody has got to be the gatekeeper, and has got to stand up and make simplification a priority. I view that as the job of this committee and of the other tax-writing committee, but I really view it as the job of the administration and the Treasury Department, too, and that was one reason why we wrote the letter to Secretary Rubin expressing concern about the budget proposal because we would hope that their role would be to resist these kind of proposals rather than to make them.

Senator BREAUX. I appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

We appreciate each of you being here today. My concern is that we do talk about this from time to time, and we do take a bit of action here and there, but we do not have real simplification. Yet, we are all guilty because we do push particular tax interests that we think are beneficial.

I agree with what you are saying, Ms. Burlison, that people today are pretty well satisfied. I am not so sure that is going to be true when times become a little tougher. Let's hope that does not happen, but I suspect it might.

I think the real question is what is the most realistic way of approaching this problem. Should we be trying to take one or two areas at a time, like AMT now and child care or education, or should we really try to create a task force to put the whole ball of wax together and have a major reform?

Any comments on that?

Mr. WILKINS. As I said, our first comment was to do what you can to control the pace of change, but to address your question more directly, I think you have to be sure that whatever you do, you have the resources in terms of your economic professional staffs, people that can ratify what you are doing, your own professional staffs, the professional staffs of the Treasury, that you do not stretch yourselves too thin. You want to be able to bring a lot of resources to bear on the particular problem that you are solving.

I am skeptical that you can really bring an adequate amount of resources to an enormous code-wide or subchapter-wide proposal, but I think you can select a handful of areas and fix them. You could do a great deal of good by focussing attention on some of the things that have been discussed today.

The CHAIRMAN. Any further comment?

Ms. BURLISON. I would concur that you want to address the areas that the shoe is pinching tightest or about to.

You have heard a lot about AMT today, and as practitioners, we thank you for allowing us to dodge that bullet in 1999 because AMT, for 1 year, was lifted from personal credits.

The CHAIRMAN. Sure.

Ms. BURLISON. That in and of itself, I think, increased the contentment within our offices for not having to explain why people have AMT when their total income is $40,000.

So, when you have an issue like that, that is very immediate, that needs attention right away.

Mr. STEINBIS. The other one that needs attention right away is the phase-outs, have them standardized. That would be a simple one to start with, and then work with the larger ones like AMT and make it possibly simpler.

The CHAIRMAN. Sure.

Mr. LIFSON. And remember, if only a million people pay AMT, there is probably 5 or 6 million people calculating it.

The CHAIRMAN. Right.

Mr. LIFSON. Do not forget the number of people that have to calculate it.

The CHAIRMAN. I do not.

Mr. LIFSON. And include them in your confused, concerned, and distressed taxpayer category.

Mr. STEINBIS. And do not forget, whatever you do here will affect a State, and the State will probably tag on in some way or not tag on, and that also has an interplay as well.

The CHAIRMAN. Thank you very much for being here. Let us hope this pushes us at least one step forward. This is a problem, and there really is no easy solution.

Right now, we all know taxes are going to probably be a major issue in the Presidential election. So it is easy to talk about, but it is hard to perform.

We appreciate your contribution.

Mr. STEINBIS. Thank you.

Ms. BURLISON. Thank you.

Mr. LIFSON. Thank you.

Mr. WILKINS. Thank you.

The CHAIRMAN. The committee is in recess.

[Whereupon, at 11:55 a.m., the committee was adjourned.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF KATHY T. BURLISON

Mr. Chairman and Members of the Committee:

I'm Kathy Burlison. I appreciate your invitation to discuss income tax complexity. My perspective is that of a tax trainer and as a front-line tax preparer who has prepared or reviewed thousands of returns over 15 tax seasons. My views this morning are my own and not necessarily those of H&R Block.

I've been working in the tax field since 1983, when I took an H&R Block tax course in Hawaii before beginning work as a tax return preparer. I subsequently spent four years as an assistant district manager in California. In 1989, I passed the exam to become an Enrolled Agent, qualifying me to practice before the IRS and represent taxpayers at audits. Since 1990, I've been at H&R Block headquarters in Kansas City, where I prepare training materials and continue to do returns part-time at an H&R Block Premium office. I am part of the team at H&R Block that prepares tax simplification suggestions sent annually to the Finance Committee since 1997.

I have three main points: first, complexity is a serious and growing problem that affects many but not all taxpayers; second, some tax complexity is the necessary result of tailoring the tax system to complex individual circumstances and some results from Congress using the Tax Code for social or economic policy goals; and third, much can be done to simplify the present income tax without shifting tax burdens among income groups.

NOT ALL TAXPAYERS ARE BURDENED

First, the tax code is growing more complex. A major part of the compliance burden centers on businesses which are not the subject of today's hearing. But the burden of individual complexity has historically fallen heavily on about a quarter of taxpayers. High-income families with complex financial lives and the self-employed are especially affected.

The Taxpayer Relief Act of 1997 and subsequent legislation is pushing complexity further down the income ladder. It added complex calculations for capital gains, IRA changes, and new credits with multiple phaseouts. The child credit interaction with the earned income credit imposes complexity on many low-income families. Many of the Act's provisions have been revised or repaired by the IRS Reform Act of 1998 and the Omnibus Appropriations Act passed last October, but in some cases these acts added further complexity. The income averaging and loss carrybacks for farmers, for example, added considerable confusion which we saw in our offices this year. And, of course, new provisions require new IRS forms, instructions, worksheets, clarifications, and changes, some in the middle of the tax season, which in turn entail annual tax guides, tax software modifications, and retraining of tax preparers.

The alternative minimum tax (AMT) is the king of complexity. It is a second, parallel tax system installed to guarantee that no one completely escapes taxation because of tax preferences. While it still hits less than 1% of mostly wealthy taxpayers, it is projected to affect 6-8% of taxpayers in a decade, many of whom have never seen a tax shelter. To ensure that it wouldn't pinch middle-income families using nonrefundable personal credits (for children, adoption, education, the elderly or disabled, or dependent care), Congress granted limited AMT immunity for 1998; the suspension should be made permanent if the AMT isn't repealed.

But while complexity is beginning to creep into middle-income groups, it is less of a problem for most taxpayers. As Professor Slemrod of the University of Michigan testified before the National Commission on Economic Growth and Tax Reform in

1995, "For the majority of Americans with an uncomplicated financial situation, the tax system is not all that burdensome."

Millions of low-income Americans fall below the filing threshold. Of 124 million who do file a tax return, about 48 million have no income tax liability. About 52 million, or 42%, are able to use the short Form 1040A or the simple Form 1040EZ. Some 26 million are eligible to file by telephone. Over 70% of filers take the standard deduction and do not itemize. One survey found that 45% of all taxpayers spend less than 10 hours per year on their taxes. This side of the picture also deserves to be seen in considering complexity.

Why, then, do half of tax filers go to a professional preparer?

Certainly complexity is a reason. So are frequent changes in tax law, including simplifications. But many of my clients come for convenience: they're able to change the oil in their car, for example, but prefer paying a professional to allow more time for family. Many come in early to speed their refunds, which 70% of taxpayers receive and many need to pay bills. And for many clients, it's a once-a-year financial check up, a chance to talk over with someone they trust the financial and tax effects of life changes—marriages, births, moves, divorces, or retirements, in addition to advice about savings, investments, or debts. Some clients have math anxieties. Some have language problems. For some, financial illiteracy is a problem. Many of these needs would exist even with a simplified tax system.

SOME COMPLEXITY UNDERSTANDABLE

I know that when you start to write tax laws, you don't intend for them to be complex. For example, Chairman Roth's original IRA proposal was simple. But over the years, it got more complex, and this year reporting conversions from regular to Roth IRAs have proved to be among the most confusing and challenging provisions for our clients.

Some complexity comes from tailoring tax laws to fit individual circumstances. A family who itemizes deductions and has income from capital gains, dividends, interest, rent, pension or annuity disbursements, salary and other benefits, unreimbursed business expenses, and so on, has a complex financial picture. Designing laws to fit personalized circumstances is inherently complicated.

Simplification, while important, also has to be seen in context and balanced against other goals: fairness, enforceability, efficiency, savings, investment, and economic growth. A one-size-fits-all poll tax would be a lot simpler, but probably unfair since it treats people in different circumstances identically. Taxing capital gains and wage income the same would be simpler, but at the cost of other objectives like creating incentives to invest.

Some complexity relates to subsidizing favored activity that Congress feels is in the public interest. A Tax Code without an adoption credit might be simpler, but Congress uses the Tax Code to promote the social goal of more adoptions, or more education, or helping families with children, or aiding the self-employed with health insurance costs, or supporting home ownership, or encouraging retirement savings, or rewarding work over welfare. The complex earned income tax credit helps the working poor. Social programs are migrating away from government agency spending into the Tax Code. Popular tax cuts are the new delivery vehicle. Whatever the merits, that makes the Code more complex.

Budget needs also add complexity. Congress wants more bang for the buck, so it may squeeze a tax credit to fit available dollars by limiting its application or phasing it out for some income groups. By definition, narrowly targeting a tax cut to some taxpayers involves restrictions and, often, complexity. And a lot of complexity relates to defining and measuring income. That may be inescapable in any tax system.

A multi-rate tax structure isn't a cause of complexity itself since most taxpayers simply look up their tax in a table, although it may invite complicated tax minimization strategies for some taxpayers.

SOME SIMPLIFICATION POSSIBLE

I can't report that the simplification suggestions H&R Block sent Congress, or those of the American Institute of CPAs, have produced an overwhelming response, but some changes have been adopted and more can be made. Administrative changes can also help. We worked some years ago with the IRS to help create the Form 1040EZ, which is essentially a readable postcard. The IRS has a program underway to revise and simplify many of its forms and publications. That's good. It does make a difference.

Even while some Members of Congress discuss throwing out the current Tax Code, we can still improve it. Many simplification suggestions are dismissed as tinkering at the margins. But most of what Congress does is work on margins and that is still useful. Radical reforms are unlikely to be adopted. Some reforms styled as simplification may do collateral damage that outweighs their benefits, like undermining progressivity. Until better alternatives emerge, we should focus our energy on improving the system we have. We may be able to achieve significant simplification without arousing opposition by major shifts in burdens.

Many of the provisions taxpayers find most complex can be simplified in this way, including unifying definitions for the same terms, harmonizing income eligibility requirements for various credits and deductions, streamlining rules for IRAs, EITCs, and the self-employed, minimizing capital gains computations, and consolidating education benefits.

On average, Congress has passed a major tax bill every 18 months. Congress passed seven major tax bills in the 1980s, 600 Code changes in 1996, over 800 in 1997, and a major IRS restructuring in 1998. The Taxpayer Relief Act of 1997 alone contained 36 retroactive changes, 114 changes effective August 1997, 69 changes effective January 1998, 5 thereafter, and 285 new Code sections. There have been 6,493 changes in the Tax Code from 1987 through 1998, an average of almost 1.5 a day. That's a lot for taxpayers, not to mention the IRS and tax professionals, to absorb. A pause to allow everyone to catch up would be welcome.

The complexity analysis required by the IRS Reform Act should help elevate the importance of simplification in Congress, but simplification will always compete with social and economic policy goals.

I appreciate the opportunity to present my views. I and my associates at H&R Block look forward to working with the Committee and its staff to improve the tax system and make it work better for average American taxpayers.

[SUBMITTED BY SENATOR GRAHAM]

RK THURSDAY, APRIL 15, 1999 A31

Robert J. Samuelson

Backward Leap

I used to write passionately about tax reform—arguing for a simpler system, with lower rates and fewer tax preferences—but I have given up. It is a lost cause. The Clinton administration (often with the help of Republicans) has returned us to a tax system that is increasingly an instrument of social engineering, economic tinkering, partisan favoritism and propaganda. It is a giant leap backward but, barring some dramatic shift in public opinion, one that seems irreversible. Even today, when people are most agitated by taxes, no one seems to care.

The tax code is being crammed with special-interest provisions intended mainly to advertise public solidarity with some selected constituency, social group or cause. The Clinton administration wanted to endear itself to parents of college students, so it advocated (and Congress passed) a complex package of tax breaks for college tuition. Now it wants to flaunt its compassion for families caring for older parents with a $1,000 "long-term care" credit. The president's budget proposes an array of new credits, including a $2,000 credit for buying a "highly energy efficient" new home.

Even a decade ago, proposals like these were termed "tax breaks," "preferences" or "loopholes." Our present, less critical language refers to them as "targeted" tax cuts. The implication is that tax relief goes only to the deserving. The reality is that tax relief is being dispensed through a thoroughly political process that treats taxpayers with similar incomes dissimilarly—some better, some worse—depending on whether they conform to some government-approved activity or behavior.

All this has unraveled the Tax Reform Act of 1986. That law lowered rates, eliminated many tax shelters and broadened the tax base. It was a bipartisan achievement. Ronald Reagan supported it; then-Democratic Sen. Bill Bradley was a main sponsor. Mortimer Caplin, commissioner of the Internal Revenue Service under President Kennedy, describes it as the best tax law in half a century and laments today's drift. "The tax code has gotten more and more complicated by its overuse for social and economic reasons, rather than ... raising revenues," he says.

But resistance is slight. Every so often, Republicans hold congressional hearings to demonize the IRS or propose replacing the income tax with a flat tax or national sales tax. This is fairly hypocritical, because Republicans also plug targeted tax cuts. A few years ago they peddled a child tax credit for families. It was duly embraced by Clinton and enacted. Then there's the Roth IRA (individual retirement account), named after Senate Finance Committee Chairman William Roth. And Clinton stole the idea for a long-term-care credit from Republicans.

The public barely complains about the mounting complexity. One reason is the economic boom. People feel good. No one ever likes taxes, but prosperity dilutes dislike. Another reason is a huge and unplanned shift in the burden of the income tax. The surge in tax revenues—the same surge that created federal budget surpluses—has come mostly from the rich.

In 1994, for example, the one percent of taxpayers with more than $200,000 of adjusted gross income paid about 30 percent of all individual income taxes (this was double their share of income, 15 percent). By 1997, taxpayers with more than $200,000 paid 37 percent of income taxes. Much of the increase reflects stock-market gains. It helps explain a paradox: Although federal taxes are now near a record 21 percent of national income, the tax burdens of most people (including their payroll taxes) are below historic highs. This, too, muffles discontent.

Finally, people seem resigned to complexity—and computers make the complexity more tolerable. Half of tax filers use an accountant or tax preparer. H&R Block alone will submit roughly 15 million tax returns this year. Most professionals now rely on software to simplify intricate calculations. So, increasingly, do individuals. Last year 13 million taxpayers used tax software, estimates Intuit, the maker of the leading program. That's about a fifth of the people who did their own returns. In 1999, Intuit reckons that software use will grow 30 to 35 percent.

"Targeted" tax cuts are usually a smoke screen for a maze of complex, ineffective tax breaks.

What's the harm, then, of all the new tax breaks? Well, the damage is real—but invisible.

For starters, many tax breaks don't work as advertised. All the savings "incentives" (IRAs, etc.) haven't raised saving. Indeed, the personal savings rate—savings as a share of after-tax income—has fallen to zero. Clinton's tuition tax breaks probably won't make college more affordable. The easier it is for people to pay, the more colleges will charge. Unsurprisingly, the Wall Street Journal recently reported that colleges are raising tuition next fall by 3 to 5 percent—more than twice inflation.

It is not simply that tax breaks are often wasteful or ineffective. They are also deceptive and corrupting. Most targeted tax cuts invite restrictions to prevent them from becoming too expensive. So people often discover that they can't get what they think they've been promised. And, worse, the entire process promotes tax evasion and pushes the IRS to intrude itself more into people's lives.

Consider the proposed long-term-care credit. About 2 million people would qualify, says the administration. But the government also estimates that 13 million people have long-term-care needs, writes economist Martin Sullivan in the journal Tax Notes. People would qualify for the credit if a doctor certified that they need help with three "activities of daily living," such as bathing, dressing or eating. "With $1,000 of somebody else's money on the line," Sullivan notes, doctors would be under huge pressure to certify. And how would the IRS police that?

Similar shortcomings afflict most tax breaks. But who cares? Tax breaks are less an arm of social policy than an aid to politics. The aim is to seem to be doing good and to increase people's dependence on politicians. As more groups and causes acquire tax breaks, anyone left out is emboldened to seek a special break. The system becomes protected by all the constituencies that have a stake in its survival. And what was once called tax reform becomes—as I said—a lost cause.

PREPARED STATEMENT OF HON. ORRIN G. HATCH

I want to thank the Chairman for holding this hearing today. I am sure that more than one set of bleary eyes here today is due to late night struggles with the complex tax forms that have to be sent in today.

Yesterday, this Committee held a hearing on the implementation of the IRS Reorganization and Reform Act of 1998. Indeed, the reforms we passed last year will provides taxpayers with a friendlier collection agency and new taxpayer rights, but it will not address the core reason for much of the taxpayer frustration and disgust—the complexity of the tax code.

You can count me in the 66% of American taxpayers who believe that our tax code is too complex. To be sure, the taxpayers of America have plenty of reasons to be frustrated. The 1.5 million words contained on 2,862 pages of the Internal Revenue Code are enough to drive anyone crazy—and have driven about half of the taxpayers in this country to cry "uncle" and give up on preparing their own return and seek out paid tax preparers.

The average taxpayer in my home state of Utah will spend roughly 11 hours assembling receipts and documents, wading through the instruction booklet, and breaking pencils over the annual exercise of preparing their form 1040s. This 11 hours does not even include any of the accompanying schedules—these take additional hours to prepare.

How did the tax code get to this point? No one set out to deliberately create a tax code this Byzantine. The tax code of today is the accumulation of Congress' attempts over the years to influence citizens' behavior by granting incentives or assessing higher taxes. It is a function of Congress' eternal quest to achieve the elusive goal of tax fairness. Unfortunately, these efforts have combined to create a tax code that is ridiculously complex and difficult. Even the tax experts will not say it's a snap.

The tax code of today is costly for both the taxpayers and the government. The taxpayers generally perceive it as unfair; and it stifles economic growth. These are good enough reasons for me to support a declaration of simplification.

I recognize that calling for tax reform is easier said than done, but there are numerous things that can—and should—be done. We may not have consensus on how to fundamentally reform this system, but we know we've got to do something.

I am looking forward to hearing the ideas of the witnesses before us today. They are all experts in their fields and have vast experience with the tax code. More than that, they are also citizens and taxpayers. Even my friend Val Oveson, the National Taxpayer Advocate, who is from my home state of Utah, does not escape the responsibility of filling out a tax form and paying his taxes. The ideas we get from those here today will help us identify those areas most frustrating for the taxpayers. Working together, I believe that we can take positive steps to simplify the tax code for the American people.

PREPARED STATEMENT OF DAVID A. LIFSON

INTRODUCTORY COMMENTS

Mr. Chairman, and members of this distinguished committee: My name is David A. Lifson, and I am the chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the professional association of certified public accountants, with more than 330,000 members. Many of our members are tax practitioners representing one-person to mid-size to international firms, or tax directors in industry, or tax educators, or government employees. We help millions of taxpayers comply with the law, on a year-round basis.

The AICPA has long been an advocate of simplification of the tax system. The complexity of our tax law has reached the point where many taxpayers and practitioners believe that it is undermining voluntary compliance. Frequent change, the lack of deliberation in the legislative process, and the increasing magnitude and complexity of the Internal Revenue Code are serious concerns for tax professionals.

Significant problems arise from the increasing complexity of the tax law. For example:

- a growing number of taxpayers perceive the tax law to be unfair;
- it becomes increasingly more difficult for the Internal Revenue Service to administer the tax law;
- the cost of compliance for all taxpayers is increasing (of particular concern are the many taxpayers with unsophisticated financial affairs who are forced to seek professional tax return preparation assistance); and,
- complexity interferes with economic decision making.

The end result is erosion of voluntary compliance. Taxpayers and tax practitioners simply find it harder to understand and comply with the tax law. In a recent Associated Press (AP) poll, 66 percent of the respondents said that the federal tax system is too complicated. Three years ago, just under one-half of respondents in a similar AP poll said that the tax system was too complicated.

The poll also showed that more than half of those surveyed, 56 percent, now pay someone else to prepare their tax returns. This is a serious indictment of our tax system. When over half our individual taxpayers have so little comprehension of (or faith in) their tax system that they have to hire another party to prepare their returns, something is not right. Consider, too, that only about 30% of individual returns claim itemized deductions. Thus, a significant segment of those paying to have returns prepared are standard deduction filers. The AICPA firmly believes that taxpayers with relatively simple financial affairs should not have to seek professional preparation services in order to comply with the tax law.

To maintain a viable voluntary tax system, simplification must have a prominent position in the tax process. Although it should not take precedence over revenue and tax policy objectives, simplification must be an integral part of the tax legislative, regulatory, and administrative process. While a tax system that is simple for all taxpayers may never be designed, a "simpler" system is attainable, both through new legislative proposals and a review of existing tax law.

AICPA BLUEPRINT FOR TAX SIMPLIFICATION AND COMPLEXITY INDEX

The AICPA in the Blueprint for Tax Simplification, issued in 1992, identified four elements necessary to create a simpler tax system: (1) a visible constituency to communicate the need for simplification to Congress and the Administration; (2) identification of guiding principles for tax simplification; (3) identification of factors that contribute to complexity to be used in the development of a framework for analyzing the balance among equity, policy, revenue, and simplification objectives; and, (4) consideration of simplification at all stages of the legislative and regulatory process.

The Blueprint also outlined guiding principles in pursuing a simpler tax law. These are:

- the legislative process should consider the objectives of equity, efficiency and revenue needs, balancing them with simplification;
- once tax policy objectives have been identified, alternative approaches to implementing the policy should be considered to provide the simplest possible design and administration;
- the long-term benefit of any change made to simplify the tax law should more than offset any transitory complexity that results by a change;
- the law and regulations should be drafted within a rational, consistent framework;
- there should be a balance between simple general rules and more complex detailed rules;
- the benefit of a provision should be weighed against the cost of compliance; and
- tax rules should build on common industry record keeping and business practices.

The Blueprint concluded with the identification of the leading factors that create complexity: the effects of change; subjectivity; lack of consistent concepts; structural complexity; the effect on taxpayers not targeted by a particular provision; communication complexity; computations; complexity of forms; administrative issues; legal complexity; transactional application and business dynamics; diffusion of responsibility; inconsistent application of rules; and the legislative process.

From these factors, the AICPA then developed and released the Complexity Index. The Index is a tool for measuring complexity factors to assess the complexity, or simplification, of proposed tax law changes relative to existing law or competing legislative proposals. The Index is used by AICPA committees when developing legislative proposals and comments. Although we understand that complexity is a multidimensional concept and acknowledge that no single index can measure complexity in an absolute sense, the AICPA has encouraged Congressional tax writing committees and staffs to use the same or a similar index when considering and drafting proposed legislation.

INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998

The AICPA was greatly pleased when many of the concepts and factors contained in the Blueprint and Index were incorporated into the tax law complexity analysis mandated by the Internal Revenue Service Restructuring and Reform Act of 1998.

The Act requires an annual tax law analysis of sources of complexity in administration of the Federal tax laws to be conducted by the Commissioner of Internal

Revenue. This analysis will draw on such information as: questions frequently asked by taxpayers; common errors on tax returns; areas of law which frequently result in disagreements between taxpayers and the IRS; and areas of law lacking published guidance.

The Act also requires the Joint Committee on Taxation, in conjunction with the IRS and the Treasury Department, to develop a complexity analysis of any proposed legislation that has widespread applicability to individuals or small business. This analysis will draw on such information as: an estimate of the number of taxpayers affected by a provision; the income level of affected taxpayers; the effect of a proposed change on tax forms and published guidance; any additional record keeping requirements imposed on taxpayers; and an estimated cost to taxpayers to comply with the provision.

Now that a framework for analyzing complexity has been established and tools are being developed to measure a proposal's effect on the complexity of the law, steps must be taken to ensure that the tools are used and that the information obtained is formally considered in the legislative and regulatory process. This final element is critical to achieving a simpler tax system for many taxpayers.

RECENT LEGISLATIVE PROPOSALS

In recent years, tax legislation has increasingly included complex thresholds, ceilings, phase-ins, phase-outs, effective dates, and sunset dates in an effort to provide benefits to numerous specific groups within the limits of revenue neutrality. For example, the President's Fiscal Year 2000 Budget tax proposals, as drafted, continue this trend through numerous, additional targeted credits. While these credits are well- intentioned, cumulatively they would further weigh down our tax system with complexity. Many average taxpayers do not understand the benefits to which they are currently entitled. While it is still early, we believe that taxpayers will, all too frequently, omit from their 1998 tax returns some of the benefits intended for them. In fact the Wall Street Journal just reported on April 12 that the IRS had discovered that 30,000 filers eligible for the child tax credit had filled out their tax return wrong. Other taxpayers will be disappointed to learn that they do not qualify for benefits that they have heard about because of complex phase- out rules written in fine-print. Taxpayers will have difficulty in complying, much less planning for, and this level of complexity.

We understand that delivering politically popular benefits within budget constraints often results in simplification being sacrificed. However, the Administration's current proposals are only the continuation of a growing trend to complicate our tax structure through targeted benefits. For example, the 1997 Taxpayer Relief Act enacted the new dependent child credit (up to $400 in 1998 for dependent children under 17 years of age) that had strong political support from both political parties. The AICPA opposed the proposal, not on policy grounds but solely based on simplification of the law. Rather than introduce a new form, a new set of calculations and a new set of income phase- outs, a rough equivalent of the desired objective could have been achieved by increasing the dependency exemption available for children under 17. Since exemption deductions already phase-out for the wealthy, the increased amount would not have been available for our most affluent taxpayers. Obviously, we were politically incorrect. But, we think we were correct in the context of tax simplification.

The Administration's current revenue proposals contain numerous provisions affecting individuals, such as a new long-term care credit, a new disabled workers tax credit, the child and dependent care tax credit expansion, the employer-provided educational assistance exclusion extension, a new energy efficient new homes credit, the electric vehicles credit extension, AMT relief extension, a new D.C. homebuyers credit, optional self-employment contributions computations, a new severance pay exemption, and a new rental income inclusion.

We are very concerned about the increasing complexity of the tax law as a result of targeted individual tax cuts. The 1997 Taxpayer Relief Act contained several targeted individual tax cuts that were first effective for 1998 individual income tax returns. These provisions, while providing tax relief to certain individuals, have greatly increased the complexity of the preparation of individual income tax returns. This increased compliance burden is borne mostly by lower income taxpayers who can least afford the cost of hiring a professional income tax return preparer.

IRS National Taxpayer Advocate W. Val Oveson, in his first report to Congress, stated that increasing tax law complexity is imposing significant compliance and administrative burdens on the IRS and taxpayers. The report also cited the increasing complexity caused by the targeted individual tax cuts contained in the 1997 Taxpayer Relief Act. While we are not commenting on the policy need for these provisions, we note that Congress must consider the general ability to administer these provisions.

The Administration's tax proposals contain 28 new targeted tax cuts. Many of these provisions have limited applicability. Unfortunately, the way these provisions are drafted, with different income limits for each provision, taxpayers will need to make many additional tax calculations just to determine if they are eligible for the tax benefit. The Administration's tax proposals will add several additional income limits to the Internal Revenue Code.

Below are a few examples of provisions in the Administration's tax proposals that have different phase-out limits:

- the long-term care credit and disabled workers tax credit would be phased out "by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified adjusted gross income (AGI) exceeds" $110,000 (married filing a joint return taxpayers), $75,000 (single/head of household), or $55,000 married filing separate;
- the first-time D.C. homebuyers credit phases out for individuals with AGI between $70,000 and $90,000 ($110,000 to $130,000 for joint filers);
- the severance pay exemption would not apply if the total severance payments received exceed $75,000;
- the expanded child and dependent care credit proposal would allow taxpayers the 50 percent credit rate if their AGI is $30,000 or less, then the credit rate would be reduced by one percentage point for each additional $1,000 of AGI in excess of $30,000, and taxpayers with AGI over $59,000 would be eligible for a 20 percent credit rate; and
- the student loan interest deduction (to which the President's proposal would eliminate the current 60-month limit) phases out ratably for single taxpayers with AGI between $40,000 and $55,000 and between $60,000 and $75,000 for married filing a joint return taxpayers.

This type of law, with so many different phase-out limits, provides incredible challenges for middle-income taxpayers, in determining the amount of benefit to which they are entitled. We suggest common phase-out limits among all individual tax provisions in order to target benefits to one of three uniform groups and simplify the law. Our phase-out simplification proposal is described in a later section of this testimony.

Another problem with these targeted tax cuts is that the impact of the alternative minimum tax (AMT) on these cuts is not adequately addressed. This is evidenced by the provision in the IRS Restructuring and Reform Act of 1998, and the provision in the Administration's tax proposals, that provide temporary relief from the AMT for individuals qualifying for some of the targeted tax credits. We believe that the individual alternative minimum tax needs to be simplified; our proposal is also included in our testimony.

AICPA SIMPLIFICATION EFFORTS

Over the years the AICPA has made numerous, regular submissions of specific tax simplification recommendations. Examples include the annual release of "The AICPA Top Ten List of Tax Law Complexities" and the April 1997 comprehensive package of simplification proposals which included recommendations to simplify the tax law for individuals, small businesses, employee benefit taxation, trust and estate taxation, corporation and shareholder taxation, financial service and product institutions taxation, and international taxation. The AICPA is once again initiating a project to develop a comprehensive package of tax simplification recommendations that we hope to share with this committee later in the year.

In the meanwhile, our statement below contains the AICPA 1999 Top Ten List of Tax Laws Complexities that would significantly simplify the tax law for individuals. We also encourage this committee to consider alternatives to targeted tax credits and cuts, including an increased standard deduction, increased personal exemption amount, reduction of the income level at which current rates apply, and relief from the marriage penalty.

SPECIFIC SIMPLIFICATION RECOMMENDATIONS—TOP TEN LIST OF TAX LAW COMPLEXITIES

Simplification of the Individual Alternative Minimum Tax (AMT)

Present Law

Complexity of AMT

The AMT is one of the most complex parts of the tax system. Each of the adjustments of Internal Revenue Code (IRC) section 56, and preferences of IRC Section 57, requires computation of the income or expense item under the separate AMT system. The supplementary schedules used to compute many of the necessary adjustments and preferences must be maintained for many years to allow the computation of future AMT as items turn around.

Generally, the fact that AMT cannot always be calculated directly from information on the tax return makes the computation extremely difficult for taxpayers preparing their own returns. This complexity also calls into question the ability of the Internal Revenue Service to audit compliance with the AMT. The inclusion of adjustments and preferences from pass-through entities also contributes to the complexity of the AMT system.

Effects of the Taxpayer Relief Act of 1997 and AMT on Individual Taxpayers

If the Administration's budget proposal on temporary AMT relief expansion is not enacted, several tax credits included in the Taxpayer Relief Act of 1997 will have a dramatic impact on the number of individuals who will find themselves subject to the AMT. For many, this will come as a real surprise and, in all likelihood, will cause substantial problems for the Internal Revenue Service, which will have to redirect significant resources to this area in the future to ensure compliance, educate taxpayers, and handle taxpayer questions. We believe the Administration's proposal should be for permanent AMT relief rather than just temporary two-year relief.

Most sophisticated taxpayers understand that there is an alternative tax system, and that they may sometimes wind up in its clutches; unsophisticated taxpayers, however, may never have even heard of the AMT, certainly do not understand it, and do not expect to ever have to worry about it. Unfortunately, that is changing—and fairly rapidly—because a number of the more popular items, such as the education and child credits that were recently enacted, offset only regular tax and not AMT. While Congress changed the law—for 1998 only—to allow these credits against AMT, it is now faced with the need to continue revisiting this issue if there is to be continuing relief. Thus, the question of nonrefundable credits as an AMT offset has joined the unenvied list of "expiring provisions" or "extenders" for which it becomes necessary to continue finding revenues to pay for another year or two of what should be a matter of simplicity and equity.

Indexing of AMT Brackets and Exemption

Numerous anecdotal examples now indicate the likelihood that taxpayers with adjusted gross incomes in the $60,000-$70,000 range (or below) will be subject to AMT in the next few years. Aside from the fairness issues involved—this is not the group that the AMT has ever been targeted to hit—we see some potentially serious compliance and administration problems. Many of these taxpayers have no idea that they may be subject to the AMT (if, indeed, they are even aware that there is an AMT). Thus, we anticipate large numbers of taxpayers not filling out a

Form 6251 or paying the AMT who may be required to do so, thus requiring extra enforcement efforts on the part of the IRS to make these individuals (most of whom will otherwise be filing in absolute good faith) aware of their added tax obligations. Further, IRS notices to these taxpayers assessing the proper AMT may well be perceived as unfair, subjecting the IRS to unwarranted criticism that should be directed elsewhere.

Recommended Changes

Due to the increasing complexity, compliance problems, and a perceived lack of fairness towards the intended target, the AICPA supports eliminating the individual AMT altogether. These provisions have been in the law since 1978 (with amendments from time to time), and substantive changes to the regular tax regime in the past 20 years have resulted in much of the AMT impact now coming from disallowance of itemized deductions, with a slowly growing secondary effect from the failure to index tax brackets and exemptions. Thus, the policy underpinning of the AMT which was present in 1978 has been greatly diluted.

While we are concerned with those who have to pay the AMT based upon mechanical rules that leave a lot to be desired from a policy perspective, we also note that many non-AMT payers must still be AMT filers. We would be interested in seeing statistics as to the number of individual taxpayers who struggle to fill out Form 6251 just to show they do not have an AMT liability. To fill this form out correctly is one of the most baffling experiences a taxpayer can go through—not because the IRS can't design forms (they do a terrific job overall), but because the law is so incomprehensible it defies being reduced to a set of easily derived numbers and simple instructions.

For these reasons, and others described above, we believe the individual AMT is an appropriate candidate for repeal. We do, however, recognize that there is no simple solution to the AMT problem given the likely revenue loss to the government. If repeal is not possible, Congress should consider the following:

1. Increasing and/or indexing the AMT brackets and exemption amounts.
2. Eliminating itemized deductions and personal exemptions as adjustments to regular taxable income in arriving at alternative minimum taxable income (AMTI) (e.g., all—or possibly a percentage of—itemized deductions would be deductible for AMTI purposes).
   A. At the very least, state income taxes should no longer be an adjustment. There is very little fairness in concluding that a resident of California, the District of Columbia, or New York should have a higher likelihood of incurring the AMT than a resident of Texas, solely for making a choice of state in which to live or work.
3. Eliminating many of the AMT preferences by reducing for all taxpayers the regular tax benefits of AMT preferences (e.g., require longer lives for regular tax depreciation).
4. Allowing certain regular tax credits against AMT (e.g., low- income tax credit, tuition tax credits)—permanently, rather than just for the next two years.
5. Providing an exemption from AMT for low and middle-income taxpayers with regular tax AGI of less than $100,000.
6. The impact of AMT in all future tax legislation.

Contribution to Simplification

The fairness goal of the AMT has created hardship and complexity for many taxpayers who have not used preferences to lower their taxes. Many of these individuals are not aware of these rules and complete their return themselves, causing confusion and errors. The 1997 law and the impact of inflation on indexed tax brackets and the AMT exemption are causing more lower-income taxpayers to be inadvertently subject to AMT. Increasing and/or indexing the AMT brackets and exemption (recommendation 1) would solve this problem.

Under recommendation 2, those individuals who are affected only by itemized deductions and personal exemption adjustments would no longer have to compute the AMT. Itemized deductions are already reduced by the phase out for high income taxpayers, 2 percent AGI miscellaneous itemized deduction disallowance, 7.5 percent AGI medical expense disallowance, $100 and 10 percent AGI casualty loss disallowance, and the 50 percent disallowance for meals and entertainment. Similarly, the phase out of exemptions already affects high-income taxpayers. It is also worth noting that because state income taxes vary, taxpayers in high income tax states may incur AMT solely based on the state in which they live, while other taxpayers with the same AGI, but who live in states with lower or no state income taxes, would not pay AMT. This unintentionally works to the disadvantage of residents of high tax states.

In addition, under recommendation 3, many of the AMT preferences could be eliminated by reducing for all taxpayers the regular tax benefits of present law AMT preferences (e.g., require longer lives for regular tax depreciation). This would add substantial simplification to the Code, recordkeeping and tax returns.

Under recommendation 4, those who are allowed regular tax credits, such as the low income or tuition tax credits, would be allowed to decrease their AMT liability by the credits. This would increase simplicity and create fairness. Compliance would also be improved.

Under recommendation 5, fewer taxpayers will be subject to AMT and its associated problems. By increasing the AMT exemption to exclude low and middle income taxpayers, the AMT will again be aimed at its original target—the high-income taxpayer.

In conclusion, we see the AMT as becoming more prevalent and causing considerable disillusion to many taxpayers whom do not see themselves as wealthy and who will believe they are being punished unfairly. The AMT will apply to many taxpayers it was not originally intended to affect. We believe our proposals offer a wide range of ways to help address this problem.

Simplification of Earned Income Tax Credit

Present Law

The refundable earned income tax credit (EITC) was enacted in 1975 with the policy goals of providing relief to low-income families from the regressive effect of social security taxes, and improving work incentives among this group. According to the IRS, EITC rules affect almost 15 million individual taxpayers.

Over the last few years, the most common individual tax return error discovered by the IRS during return processing has been the EITC, including the failure of eligible taxpayers to claim the EITC, and the use of the wrong income figures when computing the EITC.

The frequent changes made over the past twenty years contribute greatly to the credit's high error and noncompliance rates. Some examples of frequent changes and complexities follow. As part of the health insurance deduction act that Congress passed in 1995, a new factor was added to determining eligibility—the amount of interest (taxable and tax-exempt), dividends, and net rental and royalty income (if greater than zero) received by a taxpayer, even if total income is low enough to otherwise warrant eligibility for the EITC. A threshold of this type of disqualified income was set at $2,350 in 1995, was then altered as part of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 to be $2,200, and goes to $2,300 for 1998. In addition, in 1996, capital gain net income and net passive income (if greater than zero) that is not self-employment income were added to this disqualified income test.

In 1996, the credit computation became even more complicated, with the introduction of a modified AGI definition for phasing out the credit, wherein certain types of nontaxable income need to be considered and certain losses are disregarded. Specifically, nontaxable items to be included are: tax-exempt interest, and nontaxable distributions from pensions, annuities, and individual retirement arrangements (but only if not rolled over into similar vehicles during the applicable rollover period). The losses that are to be disregarded are:

- net capital losses (if greater than zero);
- net losses from trusts and estates;
- net losses from non-business rents and royalties; and
- 50 (changed to 75% in 1997) percent of net losses from businesses, computed separately with respect to sole proprietorships (other than in farming), sole proprietorships in farming, and other businesses—but amounts attributable to business that consist of performance of services by an individual as an employee are not taken into account.

In addition to the prior requirement that a taxpayer identification number (TIN) be supplied for all qualifying children, starting in 1996, individuals are also required to be authorized to be employed in the U.S. in order to claim the credit. Failure to provide a correct TIN is now treated as a mathematical or clerical error.

In 1997, as part of the Taxpayer Relief Act of 1997 (TRA 97), new restrictions are placed on the availability of the EITC. For example, taxpayers who improperly claimed the credit in earlier years are denied the credit for a period of years. If the improper claim was due to fraud, the disallowance period is ten years after the most recent tax year for which the final determination is made. If it was due to reckless or intentional disregard of the rules, the disallowance period is two tax years after the most recent tax year for which the final determination was made. Taxpayers who are denied the EITC for any tax year as a result of tax deficiency procedures must demonstrate eligibility for the credit and provide additional information to the IRS in order to claim the credit in any later tax year.

In addition, the 1997 law increases from 50% to 75% the amount of net losses from carrying on trades or businesses that is disregarded in determining modified AGI. The 1997 legislation also includes the following items in determining modified AGI for the credit: tax-exempt interest received or accrued during the tax year; and non-taxable distributions from pensions, annuities, or individual retirement plans (if not rolled over into similar vehicles during the rollover period). The 1997 law provides that workfare payments are not earned income for EITC purposes.

The credit has been changed 13 times (1976, 1977, 1978, 1979, 1984, 1986, 1988, 1990, 1993, 1994, 1995, 1996 and 1997) and now is a nightmare of eligibility tests, requiring a maze of worksheets. Computation of the credit currently requires the taxpayer to consider 9 eligibility requirements:

- the number of qualifying children—taking into account relationship;

- residency test;
- age test;
- the taxpayer's earned income—taxable and non-taxable;
- the taxpayer's AGI;
- the taxpayer's modified AGI;
- threshold amounts;
- phase out rates; and,
- varying credit rates.

To claim the credit, the taxpayer may need to complete:

- a checklist (containing 9 complicated questions);
- a worksheet (which has 10 steps);
- another worksheet (if there is self-employment income); and
- a schedule with 6 lines and 2 columns (if qualifying children are claimed).

For guidance, the taxpayer may refer to 7 pages of instructions (and 28 pages of IRS Publication 596). The credit is determined by multiplying the relevant credit rate by the taxpayer's earned income up to an earned income threshold. The credit is reduced by a phase-out rate multiplied by the amount of earned income (or AGI, if less) in excess of the phase-out threshold.

While Congress and the IRS may expect that the AICPA and its members can comprehend the EITC intricacies and the many pages of instructions and worksheets, it is unreasonable to expect those individuals entitled to the credit (who will almost certainly NOT be expert in tax matters) to deal with this complexity. Even our members, who tend to calculate the credit for taxpayers as part of their volunteer work, find this area to be extremely challenging.

Our analysis suggests that most of the EITC complexity arises from the definitional distinctions in this area. While each departure from definitions used elsewhere in the Code can be understood in a context of accomplishing a specific legislative purpose, the sum of all the definitional variances causes this IRC Section to be unmanageable by taxpayers and even the IRS. We recognize that many of the additions and restrictions to the credit over the years were well intended. However, the rules are so complex that the group of taxpayers to be benefited finds them incomprehensible and are not effectively able to claim the credit to which they are entitled.

Recommended Changes

We recommend that Congress adopt the following changes to the EITC.

1. Simplify definitions and the calculation.
2. Define "earned income" as taxable wages (Form 1040, line 7) and self-employment income (Form 1040, line 12).
3. Modify the "qualifying child" rules.
   A. Replace the "qualifying child" definition with the existing "dependent child" definition.
   B. Increase the incremental amount of credit provided for two children versus one child.
   C. Use the dependency exemption rather than the EITC to provide benefits relating to children.
4. Combine and expand the denial provision.
   A. Deny the credit for taxpayers with: foreign earned income, alternative minimum tax liability, and AGI that exceeds earned income by $2,200 or more.

Contribution to Simplification

Instructions and computations would be greatly simplified. The error rate should be dramatically reduced.

Simplification of Phase-Outs Based on Income Level

Present Law

Numerous sections in the tax law provide for the phase-out of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is currently no consistency among these phase-outs in either the level of income, the range of income over which the phase-outs apply, or the method of applying the phase-outs. Furthermore, the ranges for a particular phase-out often differ depending on filing status, but even these differences are not consistent. For example, the traditional IRA deduction phases out over a different range of income for single filers than it does for married-joint filers; whereas the

$25,000 allowance for passive losses from rental activities for active participants phases out over the same range of income for both single and married-joint filers. Consequently, these phase-outs cause inordinate complexity, particularly for taxpayers attempting to prepare their tax returns by hand; and the instructions for applying the phase-outs are of relatively little help. See the attached Exhibits for a listing of most current phase-outs, including their respective income measurements, phase-out ranges (for 1998) and phase-out methods.

Note that currently many the phase-out ranges for married-filing- separate (MFS) taxpayers are 50 percent of the range for married- filing-joint (MFJ), while many of the phase-out ranges for single and head of household (HOH) taxpayers are 75 percent of married- joint. That causes a marriage penalty when the spouses' incomes are relatively equal.

Recommended Changes

Simplification could easily be accomplished by eliminating phase- outs altogether. However, if that is considered either unfair (simplicity is often at odds with equity) or bad tax policy, significant simplification can be achieved by creating consistency in the level of income, the income range of phase- out and the method of phase-out.

Instead of the approximately 20 different phase-out ranges (shown in attached Exhibit A), we recommend only three—at levels representing low, middle, and high income taxpayers.

If there are revenue concerns, the ranges and percentages could be adjusted, as long as the phase-outs for each income level group (i.e., low, middle, high income) stayed consistent across all relevant provisions. In addition, marriage penalty impact should be considered in adjusting phase-out ranges for revenue needs.

We propose that all phase-out ranges for MFS taxpayers should be the same as those for single and HOH taxpayers, which would be 50 percent of the range for MFJ taxpayers.

The benefits that are specifically targeted to low-income taxpayers, such as the earned income credit, elderly credit, and dependent care credit, would phase-out under the low-income taxpayer phase-out range. The benefits that are targeted to low and middle income taxpayers, such as the traditional IRA deduction and education loan interest expense deduction, would phase-out under the middle-income taxpayer phase-out range. Likewise, those benefits that are targeted not to exceed high income levels, such as the new child credit, the new education credits and education IRA, and the new Roth IRA, as well as the existing law AMT exemption, itemized deductions, personal exemptions, adoption credit and exclusion, series EE bond exclusion, and section 469 $25,000 rental exclusion and credit, would phase-out under the high-income taxpayer phase-out range.

Additionally, instead of the differing methods of phase-outs (shown in attached Exhibit B), the phase-out methodology for all phase-outs would be the same, such that the benefit phases out evenly over the phase-out range. Every phase-out should be based on adjusted gross income (AGI).

PROPOSED ADJUSTED GROSS INCOME LEVEL RANGE FOR BEGINNING TO END OF PHASE-OUT FOR EACH FILING STATUS

Category of Taxpayer	Married Filing Joint	Single & HOH & MFS
LOW-INCOME	$15,000-$37,500	$7,500-$18,750
MIDDLE-INCOME	$60,000-$75,000	$30,000-$37,500
HIGH-INCOME	$225,000-$450,000	$112,500-$225,000

Contribution to Simplification

The current law phase-outs complicate tax returns immensely and impose marriage penalties. The instructions related to these phase-outs are difficult to understand and the computations often cannot be done by the average taxpayer by hand. The differences among the various phase-out income levels are tremendous. Either the phase-outs should be eliminated and the same goal accomplished with a lot less complexity by adjusting rates, or at least the phase-outs should be made applicable at consistent income levels (only three) and applied to consistent ranges using a consistent methodology. This would ease the compliance burden on many individuals. If there were only three ranges and only one methodology, it would be much easier to recognize when and how a phase-out applies. Portions of numerous Internal Revenue IRC Sections could be eliminated. By also making the MFJ phase- out ranges double the ranges applicable to single individuals, and by making the MFS ranges the same as single individuals, the marriage penalty associated with phase-out ranges would be eliminated. (See Exhibit A for selected AGI phase-out amounts and Exhibit B for current methods of phase-out.)

Eliminate the Marriage Penalty

Present Law

Under the current tax system, a marriage penalty and marriage bonus exist. The marriage penalty/bonus results when two married individuals have a greater (penalty) or smaller (bonus) tax liability as compared to two similarly situated single individuals (i.e., individuals with the same total incomes). The marriage penalty is likely an unintended result from prior legislative efforts to be equitable. As each Congress introduces changes to the Code, complexity and unintended tax effects often result. There are at least 63 provisions in the Internal Revenue Code where tax liability depends on whether a taxpayer is married or single. Most of these differences were created to be fair; to target benefits to specific taxpayers, or to prevent abuses. Some examples are the tax rates, standard deduction, and earned income tax credit, as well as social security benefits taxation, capital loss limits, IRAs, dependent care credit, child credit, and education tax incentives.

The two major factors that have created the marriage penalty problems are:

1. The "stacking of income" problem, resulting from the different and progressive tax rate/bracket schedules applicable to different filing statuses, and
2. Different income thresholds and phase-outs of deductions and credits for single versus married taxpayers.

The progressive tax rate/bracket schedules impose a higher marginal tax on combined spousal earnings, as compared to two single persons. Additionally, the tax brackets for married filing joint are not twice as wide as the brackets for single taxpayers, and the tax brackets for married filing separately do not equate to the tax brackets for single taxpayers. We refer to this phenomenon as the "stacking of income" problem and there are a variety of ways to address it.

The second factor contributing to the marriage penalty is the large number of provisions that phase-out based on income levels that may or may not differ based on marital/filing status. The TRA 97 significantly increased the provisions with different phase-outs for different filing status (i.e., based on joint, single, or married filing separately).

Recommended Changes

The AICPA has been studying this area for many years and recommends that the marriage penalty be eliminated or reduced. There are a number of possible approaches to address the marriage penalty problem.

1. Provide a deduction to reduce the marriage penalty, such as the two-earner deduction. This would be the simplest solution to implement, and would eliminate some, but not necessarily all, of the marriage penalty and could add to marriage bonuses. It would have to apply for both regular tax and alternative minimum tax (AMT) and not be subject to an AGI phase-out to be fully effective.
2. Provide on one return, a separate calculation of each spouse's taxable income and use one tax rate schedule that would apply to all individuals. The income and deductions of each spouse could be allocated in a variety of ways, e.g., by property ownership, by AGI, by percentage of earned income, 50/50, or in the parties' discretion. In our opinion, conceptually, this one-return, separate calculation proposal could produce the most equitable system. However, any allocation of income and deductions adds complexity in return filing and tax administration. The total increase in complexity will depend on the allocation methods used. Many states that have an income tax, such as Virginia, use this approach.
3. Provide a tax credit to reduce the marriage penalty. This would eliminate some, but not necessarily all, of the penalty and could add to the marriage bonus. It would have to apply for both regular tax and AMT to be fully effective. Several considerations would have to be taken into account, such as the complexity in the calculation, the treatment of carryovers and carrybacks, and the priority ordering of the many tax credits that could apply.
4. Adjust/broaden the current rate/bracket schedules applicable to married individuals. The joint schedule could be modified to eliminate the marriage penalty (by increasing the joint brackets to twice the single brackets) or to reduce the penalty. Another approach would be to conform the married filing separate and single rate/bracket schedules (such as in Arizona). This approach would be

better than the current system and could be viewed as elective complexity for those couples that chose to file separately.

5. Adopt standard phase-outs for three income levels—low, middle, and high-income taxpayers (rather than the 20 current levels), and adopt one standard phase-out method. This would eliminate marriage penalties related to phase-outs, since the joint amounts would be twice the single ranges, and the phase-out ranges applicable to married filing separate taxpayers would be the same as those for single taxpayers.

In addition, there are related tax problems that arise because of marriage and divorce, and we urge the Committee to give these matters consideration. For example, the treatment of carryover tax attribute rules and NOL computations in divorce situations need modification. We also note that various IRC regulations (i.e., under IRC Sections 108, 121, 154, 163, 1041, and 6013) regarding spouses and divorce situations need to be amended.

This recommendation discusses a number of possible approaches to address the marriage penalty problem. However, each of these provisions needs to be thoroughly analyzed in order to provide the economic, tax, and social benefits that Congress determines is appropriate. Further, to eliminate marriage penalties and improve simplification, standard phase-outs (with joint ranges being twice the single and married filing separate ranges) for three income levels—low, middle, and high-income taxpayers (rather than the 20 current levels)—and one standard phase-out method should be adopted.

Contribution to Simplification

By eliminating or reducing the marriage penalty and marriage bonus, the tax system would become "marriage neutral." Tax complexities arising out of marriage and divorce would be reduced and the tax system would be made more rational and equitable.

Simplification of Employee vs. Independent Contractor

Present Law

The rules relating to classification of a worker as an employee or independent contractor are unclear. This results in needless confusion and potentially large tax assessments for businesses that are attempting to comply with the law.

Recommended Changes

A bill (S. 344 Independent Contractor Simplification and Relief Act of 1999) simplifying the classification of workers was introduced in the Senate on February 9, 1999 by Senator Christopher Bond (R-MO). This bill establishes a safe harbor for businesses classifying workers as independent contractors when either of the following two criteria are met:

- A worker demonstrates economic and workplace independence meeting a set of stipulated criteria, and a written agreement exists between the parties; or
- A worker conducts business through a corporation or limited liability company, the worker does not receive benefits from the service recipient, and a written agreement exists between the parties.

Contribution to Simplification

Until taxpayers are provided with clear-cut rules by Congress, this area will continue to provide many uncertainties for small business owners, as well as a continuation of the many battles between taxpayers and the Internal Revenue Service. This issue is a top priority of many small business organizations, including the 1995 White House Conference on Small Business and the U.S. Chamber of Commerce. Even the Treasury Department has testified that the 20-factor test, historically used by the Internal Revenue Service to classify workers, is confusing and does not yield "clear, consistent, or even satisfactory answers, and reasonable persons may differ as to the correct classification."

Simplification of the Kiddie Tax

Present Law

The 1986 Tax Reform Act introduced the so-called "kiddie tax" which taxes the net unearned income of children under the age of 14 at the parents' tax rate. While at first this seems to be straight-forward approach, it has evolved into a very complicated calculation. When first enacted in 1986, there was not a preferential tax rate for capital gains. The introduction of the maximum 28% (now 20%) capital gain rate has further complicated the situation. Under certain limited circumstances, parents can elect to include their children's income on their return. However, the election in not available for parents of a child with any earned income, unearned income in excess of $5,000, capital gains, withholding or estimated tax payments.

Instructions for utilization of Form 8615, "Tax for Children Under Age 14 Having Investment Income of More Than $1,200," cannot be contained on the reverse of the form. Instead, the IRS has issued Publication 929, a 20-page booklet which provides the "hidden worksheets" that allow the taxpayer, or the return preparer, to calculate the child's taxable income, as well as the tax. In situations in which there are multiple siblings falling within this provision, the complexity expands. Similarly, if a child is subject to the AMT, additional calculations are required. In the overwhelming majority of situations, the additional tax revenue generated by the "kiddie tax" appears to be insignificant when compared to the complexity of the calculations. Also, the kiddie tax provision only considers the regular tax of section 1 and not the AMT of section 55. Therefore, the way the current rules are written, if a parent must pay AMT, the children's income is still taxed at the parent's regular marginal tax rate, while the parent is taxed at the AMT rate without taking into account the child's income or the child's regular tax liability. This results in taxpayers paying more tax than if the parent and children's income are both included in the parent's AMT calculation.

Recommended Changes

The linkage of a child's taxable income to parents' and other siblings' taxable income should be repealed. Income (other than capital gains) subject to kiddie tax should be taxed at a separate rate schedule (e.g., fiduciary income tax rates). The child's capital gains should be taxed at the capital gains rates. The election to include a child's income on the parent's return should be expanded to allow all income, regardless of its nature or amount, to be included. The election could apply whether or not the child has withholding or estimated payments. There could be a check-off, similar to the current nominee interest check- off, or column added to the Form 1040 Schedules B and D so as to indicate whether the item applies to another social security number, to avoid any matching problems.

Contribution to Simplification

The suggested change would allow children's returns to stand on their own. Issues regarding missing information on one return, matrimonial issues, and unintended AMT problems would be eliminated. The perceived loophole of shifting income to minors would remain closed since fiduciary income moves to higher tax brackets at significantly lower income levels than individuals. Allowing across-the-board inclusion of a child's income on a parent's return could eliminate many children's returns and their associated compliance burdens for taxpayers and the government.

Simplification of the Individual Estimated Tax Safe Harbor

Present Law

Individuals with adjusted gross incomes of $150,000 or less may base their current year estimated taxes on 100 percent of their prior year tax. As changed by TRA 97, individuals with adjusted gross incomes in excess of $150,000 may base their current year estimated taxes on a percentage of their taxes for the prior year as follows:

Current estimated tax year	Percentage of prior year tax
1998	100
1999	105
2000	106
2001	106
2002	112
2003 and thereafter	110

Recommended Changes

The percentage of prior year tax should be 100 percent for all years.

Contribution to Simplification

In general, the estimated tax rules are complex. Prior to TRA 97, the provisions for basing individual estimated taxes on their prior year taxes were straight-forward and simple. To change to different percentages for different years results in poor tax policy, and adds needless complexity. By basing all estimates on the same percentage for all years, such as 100 percent of the prior year tax, the complex calculations that are made quarterly by taxpayers are reduced and simplicity and year-by-year consistency is added to the Code.

Simplification of Child Credits

Present Law

Effective for years beginning in 1998, taxpayers can claim a $400 ($500 in 1999 and later) credit for each qualifying child. The credit is phased out by $50 for each $1,000 of adjusted gross income over a threshold amount. The threshold amounts are $110,000 for married persons filing jointly, $55,000 for married taxpayers filing separately and $75,000 for single taxpayers.

The basic child credit is a non-refundable credit that is limited to the excess of regular tax liability over alternative minimum tax liability. (A special provision treats alternative minimum tax as equal to zero for 1998 only.) However, to the extent that the child credit is disallowed because of other refundable credits, a portion of the credit is converted into a supplemental refundable credit. Further, an additional refundable credit for taxpayers with three or more children is allowed.

Recommended Changes

We recognize that there is no one solution that will both continue to target the credit to its intended beneficiaries and limit the cost associated with its benefits. However, we recommend the following legislative changes.

1. Replace the three tier child credit system (basic, supplemental and additional) with one universal, refundable credit.
2. Consider increasing the credit amount and eliminating the exemption amount for children eligible for the credit.
3. Change the phase out levels to correspond to one of the three levels included in the AICPA Phase out Simplification proposal.
4. Make permanent the provision that allows the credit against both regular and alternative minimum tax.

Contribution to Simplification

The purpose of the child credit is to allow a reduction in tax liability in excess of that provided by the existing exemption deduction amount. The use of an additional credit amount rather than a combined credit and exemption mechanism would allow additional use of credits to be provided to low income taxpayers without the significant revenue drain associated with providing benefits to high income taxpayers.

Combining the three-tier credit into one refundable credit would eliminate confusing computations for taxpayers with low income. The current system either fosters a system prone to errors or forces taxpayers with otherwise simple returns to seek professional advice whose cost would offset a portion of the benefit of the credit.

Simplification of the Generation Skipping Transfer Tax

Present Law

In 1986, Congress enacted the generation skipping transfer tax (GST tax), which is imposed on transfers to beneficiaries more than one generation below the transferor's generation at the maximum gift and estate tax rate (55%). To determine the rate applicable to a particular transfer, the 55% rate is multiplied by the inclusion ratio (a fraction based on the GST exemption amount allocated to the transfer). A trust with a zero inclusion ratio is exempt from GST tax. Every individual is allowed a $1 million GST exemption (indexed for inflation), that may be allocated to any property subject to estate or gift tax. Married couples may treat transfers as made one-half by each spouse, in effect giving them a combined $2 million GST tax exemption. While direct transfers to grandchildren qualify for an automatic allocation of the GST exemption, transfers to a trust do not. If a GST exemption is allocated to a lifetime transfer to a trust on a timely filed gift tax return, the portion of the trust protected is generally based on the property's value at the time of the transfer. However, if the allocation is not made on a timely filed gift tax return, the portion of the trust protected is based on the value at the time of allocation. The planning necessitated by the GST tax exemption rules is very complex and fraught with traps for taxpayers and their advisors.

Recommended Changes

We propose the following legislative changes:

1. Extend the automatic GST exemption allocation rule (that currently applies to direct skips) to transfers in trust where skips are generally expected. Those taxpayers that do not want the automatic allocation to apply could elect out.
2. Provide relief for GST tax exemption allocations for those taxpayers who do not make an election because of an inadvertent failure to timely file an appropriate return and for those who demonstrate intent to have a zero inclusion ratio for a trust (substantial compliance).
3. Provide a trust severance rule.
4. Allow retroactive allocations of GST exemption when there is an unnatural order of death.

Contribution to Simplification

The following examples demonstrate some of the common problems faced by taxpayers as a result of the current GST tax rules:

1. P, a parent, transfers $10,000 a year for 10 years to a discretionary trust for a child, C, and such descendants of C, which will terminate and distribute to C when C reaches age 35. If C dies before attaining age 35, the trust is distributable to the descendants of C. If C dies before age 35 with issue when the trust assets are worth $100,000, a taxable termination occurs. Unless P allocates a GST tax exemption before C dies, the GST tax would be $55,000.
2. P transfers $1 million of stock to a trust to pay income to C for life, remainder to P's grandchild, G. If the full $1 million GST exemption is allocated to this transfer on a timely filed gift tax return, and the stock's value is $5 million at the time the property passes to G, no GST tax results. However, if the GST tax exemption is not allocated until the property has grown to $5 million, a $2.2 million GST tax would result if the property that passes is still worth $5 million when it passes to G.
3. P transfers $1 million to a trust to pay income to C until C's 35th birthday, at which time the trust property will be paid to C. If C dies before his 35th birthday, the trust property is paid to C's children. If C dies before attaining age 35 at a time when the trust property is worth $5 million, and there was no GST tax exemption allocation before C's death, there would be no opportunity to allocate such exemption and a $2.75 million GST tax would be imposed.
4. P transfers $5 million to a trust for the benefit of his five children. If one child dies, current regulations do not allow the trust to be severed so that a GST tax exemption can be allocated to the one-fifth of the trust that will primarily benefit the deceased child's children. (If five separate trusts had been created instead of one, this problem could have been avoided).

Simplification would be achieved by making automatic an allocation of GST tax exemption to those taxpayers likely to benefit, rather than requiring taxpayers to elect such an allocation. The planning necessary to take advantage of the GST tax exemption allowed by law is overly complex and often leads to errors by taxpayers. These simplification proposals would allow some relief to taxpayers that fail to make timely allocations and allow retroactive allocation in situations involving an unnatural order of death. In addition, the trust severance rule would simplify the drafting of trusts and minimize the need for creating multiple trusts simply for GST tax planning purposes.

Simplification of Half Year Requirements

Present Law

The Internal Revenue Code uses ½-year age requirements to allow individual taxpayers to begin to withdraw from their pension plans without penalty. (Example, distribution must be made after the taxpayer reaches age 59½ to avoid penalty).

Recommended Change

Change the Internal Revenue Code by eliminating the various IRC Sections that use ½ year requirements: A) Age 70½ for mandatory IRA distributions and B) Age 59½ for penalty free retirement plan withdrawals. Instead, use whole years: Age 70 and Age 59.

Contribution to Simplification

Many taxpayers, employers and banks are confused when calculating this part of the requirement. It would be easier to remember, calculate and administer, and be more user-friendly if the ages were changed.

EXHIBIT A - Selected AGI Phase-out Amounts

IRC Section	Provision	Ft Nt.	Current - Joint	Current - Single & HOH	Current - Married/Sep	*Proposed - Joint*	*Proposed - Single & HOH & MFS*
PHASE-OUT LEVELS FOR *LOW-INCOME TAXPAYERS*							
21	30 Percent Dependent Care Credit	(3)	$10,000-$20,000	$10,000-$20,000	No credit	*$15,000-$37,500*	*$7,500-$18,750*
22	Elderly Credit	(4)	$10,000-$25,000	$7,500-$17,500	$5,000-$12,500	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (No Child)	(2,3, 4)	$5,570-10,030	$10,030	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (1 Child)	(2,3, 4)	$12,260-$26,473	$12,260-$26,473	No credit	*$15,000-$37,500*	*$7,500-$18,750*
32	EITC (2 or More Children)	(2,3, 4)	$12,260-$30,095	$12,260-$30,095	No credit	*$15,000-$37,500*	*$7,500-$18,750*
PHASE-OUT LEVELS FOR *MIDDLE-INCOME TAXPAYERS*							
219	IRA Deduction w/retirement plan	(1,7,9)	$50,000-$60,000	$30,000-$40,000	No deduction	*$60,000-$75,000*	*$30,000-$37,500*
221	Education Loan Interest Exp.	(1,2,6)	$60,000-$75,000	$40,000-$55,000	No deduction	*$60,000-$75,000*	*$30,000-$37,500*
PHASE-OUT LEVELS FOR *HIGH-INCOME TAXPAYERS*							
24	Child Credit	(1,5,6)	$110,000-	$75,000-	$55,000-	*$225,000-$450,000*	*$112,500-$225,000*
25A	Hope Credit & Lifetm. Lrng. Cr.	(1,2,6)	$80,000-$100,000	$40,000-$50,000	No credit	*$225,000-$450,000*	*$112,500-$225,000*
23 & 137	Adoption Credit/ Exclusion	(1,7)	$75,000-$115,000	$75,000-$115,000	No benefit	*$225,000-$450,000*	*$112,500-$225,000*
55(d)	AMT Exemption	(1,8)	$150,000-$330,000	$112,500-$247,500	$75,000-$165,000	*$225,000-$450,000*	*$112,500-$225,000*
68	Itemized Deduction level	(2)	$124,500-	$124,500-	$62,250-	*$225,000-$450,000*	*$112,500-$225,000*
135	EE Bond int. Exclusion	(1,2,7)	$78,350-$108,350-	$52,250-$67,250	No exclusion	*$225,000-$450,000*	*$112,500-$225,000*

IRC Section	Provision	Ft Nt.	Current - Joint	Current - Single & HOH	Current - Married/Sep.	*Proposed - Joint*	*Proposed - Single & HOH & MFS*
151	Personal Exemption	(2)	$186,800-$309,300	$124,500-$247,000 HOH$155,650 - $278,150	$93,400-$154,650	*$225,000-$450,000*	*$112,500-$225,000*
IRC Section	Provision	Ft nt.	Current - Joint	Current - Single & HOH	Current - Married/Sep.	*Proposed - Joint*	*Proposed - Single & HOH & MFS*
219 (g)(7)	IRA w/spouse w/retrmt.plan	(1,6,7)	$150,000-$160,000	Not applicable	No deduction	*$225,000-$450,000*	*$112,500-$225,000*
408 A	Roth IRA Deduction	(1,6)	$150,000-$160,000	$95,000-$110,000	No deduction	*$225,000-$450,000*	*$112,500-$225,000*
408 A	IRA to Roth IRA Rollover	(1,6,7)	$100,000	$100,000	No rollover	*$225,000-$450,000*	*$112,500-$225,000*
469 (i)	$25,000 Rent Passive Loss	(1,7)	$100,000-$150,000	$100,000-$150,000	$50,000-$75,000	*$225,000-$450,000*	*$112,500-$225,000*
469 (i)	Passive Rehab. Credit	(1,7)	$200,000-$250,000	$200,000-$250,000	$100,000-$125,000	*$225,000-$450,000*	*$112,500-$225,000*
530	Education IRA Deduction	(1,6)	$150,000-$160,000	$95,000-$110,000	No deduction	*$225,000-$450,000*	*$112,500-$225,000*

Footnotes: (1) Modifications to AGI apply; (2) Inflation indexed; (3) Earned income limitations; (4) Low income only; (5) Phase-out range depends on number of children; (6) Newly enacted in 1997; (7) Also see section 221(b)(2); (8) Phase-out applies to alternative minimum taxable income rather than AGI; (9) Increases for future years are specifically provided in the statute.

EXHIBIT B - Current Method of Phase-Out

Code Section(s)	Tax Provision	Current Methodology for Phase-outs Application
21	Dependent Care Credit	Credit percent reduced from 30 percent to 20 percent in AGI range noted by 1 percent credit for each $2,000 in income
22	Elderly Credit	Credit amount reduced by excess over AGI range
23 & 137	Adoption Credit & Exclusion	Benefit reduced by excess of modified AGI over lowest amount noted divided by 40,000
24	Child Credit	Credit reduced by $50 for each $1,000 in modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
25A	Education Credits (Hope/Lifetime Learning)	Credits reduced by excess of modified AGI over lowest amount divided by 10,000 (single) and 20,000 (joint)
32	Earned Income Credit	Credit determined by earned income and AGI levels
55	AMT Exemption	Exemption reduced by 1/4 of AGI in excess of lowest amount noted
68	Itemized Deductions	Itemized deductions reduced by 3 percent of excess AGI over amount noted
135	Series EE Bonds	Excess of modified AGI over lowest amount divided by 15,000 (single), 30,000 (joint) reduces excludable amount
151	Personal Exemption	AGI in excess of lowest amount, divided by 2,500, rounded to nearest whole number, multiplied by 2, equals the percentage reduction in the exemption amounts
219	Traditional IRA w/ Retiremt. Plan	Individual retirement account (IRA) limitation ($2,000/$4,000) reduced by excess of AGI over lowest amount noted divided by $10,000
219(g)(7)	IRA w/Spouse w/ Retiremt. Plan	Deduction for not active spouse reduced by excess of modified AGI over lowest amount noted divided by 10,000
221	Education Loan Interest Expense Deduction	Deduction reduced by excess of modified AGI over lowest amount noted divided by 15,000
408A	Roth IRA	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)
408A	IRA Rollover-Roth IRA	Rollover not permitted if AGI exceeds 100,000 or if MFS
469(i)	Passive Loss Rental $25,000 Rule	Benefit reduced by 50 percent of AGI over lowest amount noted
530	Education IRA Deduction	Contribution reduced by excess of modified AGI over lowest amount noted divided by 15,000 (single) and 10,000 (joint)

PREPARED STATEMENT OF W. VAL OVESON

Mr. Chairman and Distinguished Members of the Committee:

I am pleased to make my first appearance before the Committee. As I said in the National Taxpayer Advocate's FY 1998 Annual Report to Congress, I believe my role is to be the voice of the taxpayer and the advocate of a more equitable, balanced approach to tax administration. I would like to begin by thanking you, Mr. Chairman and the Members of this Committee, on behalf of America's taxpayers for increasing taxpayer protections as part of the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98).

I would also like to thank you for inviting me to address this subject. Complexity of the tax laws is the number one problem facing taxpayers. This conclusion was stated in my Annual Report to Congress as claimed by several groups—individual and small business taxpayers, tax practitioners and professional associations and IRS Field Taxpayer Advocates. This is an important day, not only because it is the tax filing deadline, but because you recognize that there is a need to simplify the tax laws. I have always felt that tax complexity is much like the weather, "everybody talks about it, but nobody ever seems to do anything about it." I am here today to be one of those "everybodies" talking about the sources of complexity in the tax law, but also to request that this Congress, once again, come to the aid of the American taxpayer and reduce complexity in the tax code.

I. FREQUENCY AND NUMBER OF CHANGES TO TAX LAW

I congratulate Congress for trying to get a handle on complexity, as demonstrated by section 4022 of RRA 98, which calls for complexity studies to be conducted by the IRS and the Joint Committee on Taxation. I am confident that the two studies the law mandates will identify for the Congress and Federal tax administrators specific sources of complexity. The Commissioner's study will provide empirical data on how existing law affects taxpayers and a window into how the tax laws you pass get translated into what the public experiences. I am optimistic that you can use the information to reduce or mitigate existing complexity. The study by the Joint Committee on Taxation will estimate the "complexity factor" of legislation and what that means to taxpayers. I hope that you can use that information to affect what I believe to be the single most complicating factor in tax administration—the frequency and number of changes to the tax laws.

In 1986, Congress drastically changed the tax laws by enacting the Tax Reform Act (TRA 86). The goal of TRA 86 was to create a simpler, fairer and more efficient tax system. In that Act, Congress made approximately 1850 separate amendments to the Internal Revenue Code. It reduced the number of tax brackets, modified the standard deduction and made many other changes that greatly reduced complexity.

Since TRA 86 and ending in 1998, Congress made approximately 6,500 changes to Title 26 in 61 different pieces of legislation. In fact, the Taxpayer Relief Act of 1997 and RRA 98 alone made 1,260 changes to the tax code. The magnitude of the changes made by those two pieces of legislation resulted in revisions of at least 100 separate IRS forms.

This translates into additional burden for taxpayers in several significant ways. First, it is difficult for taxpayers to understand why the law changes so much. As Ben Franklin said, "Nothing is certain but death and taxes." Taxpayers may not necessarily like the certainty of paying taxes, but certainty and familiarity at least lead to an understanding of expectations. An uncertain tax system leads to cynicism and unintentional noncompliance. Second, programming the changes into brittle computer systems is expensive and fraught with risks. Third, the magnitude of the changes, particularly recently, makes it hard for the IRS to convey those changes most effectively to taxpayers. The nature of changes can be difficult for the IRS to explain simply enough in forms, instructions and publications for taxpayers. The frequency of the changes means that IRS publishes guidance reacting largely to the most pressing issues, such as those for the next filing season, resulting in fewer resources to address longer standing questions. Finally, such frequent changes make it difficult for the IRS to adequately train its employees, which inhibits the service IRS employees can provide to taxpayers. Every taxpayer has a right to expect that, in every encounter with an IRS employee, whether it is a phone call asking a question about how to fill out a return or a meeting with a revenue agent in an audit, the employee understands the current tax laws and has the skills to apply the laws to the facts and circumstances of that taxpayer. When our employees do not understand the complex and frequent changes to the laws, we cannot explain the laws to the taxpayer. Failing to understand the law results in frustration on both ends.

For example, TRA 97 changed the law regarding capital gains. It lowered the rates, provided for different rates based on the type of investment property and lengthened the holding period for long-term investments from 12 to 18 months. It resulted in the IRS completely overhauling Schedule D and in a marked increase in the amount of time and information required to complete that schedule. It also resulted in a great deal of frustration for taxpayers who had difficulty calculating their capital gains and could not get through when calling the IRS for help. While this may be an extreme example of additional complexity, imagine this or something similar multiplied by 1,260 times over the last two years.

Cumulatively, the changes over the last 13 years, but particularly TRA 97 and RRA 98, have greatly increased complexity. In conjunction with the complexity studies, I hope that you will choose to simplify the tax code. If not, then I hope that you can reduce complexity and its detrimental effects on taxpayers and the tax system by not changing the tax laws so frequently.

II. TARGETED RELIEF FOR GROUPS OF TAXPAYERS

While the frequency and number of changes to the tax laws adds a great deal of complexity, it is obviously not the only factor. Beyond those changes, I believe that targeted relief or incentives for groups of taxpayers significantly adds to the complexity of the tax law and the difficulty these taxpayers have in understanding and complying with the law. I would like to point out before I go further that I am not commenting on the merits of the policy reasons for targeted relief. Those in a position to make policy decisions may conclude that a certain subsidy is best or most simply delivered through the tax code. My goal here, like the RRA 98 studies, is to point out where the laws cause problems for taxpayers.

Recently, the Administration and Congress enacted into law many credits to help families, such as the child tax credit, the adoption credit and the education credits. These are in addition to the already-existing credits such as the child and dependent care credit, the credit for the elderly and the earned income tax credit. While these credits have resulted in lower taxes for taxpayers, they have also increased the complications these same taxpayers experience. Some of these credits sound like they involve similar concepts, but the tax law has defined them differently. For example, the definition of a "qualifying child" or "qualifying individual," used to determine eligibility to claim the child and dependent care tax credit, the child tax credit and the earned income tax credit, is different in each case. So, taxpayers who sit down to prepare their returns must fill out different worksheets or schedules and look to different instructions each time they claim similar sounding credits to determine which definition applies and whether their circumstances meet the requirements in every situation.

Further, the interaction of these targeted provisions, with each other and with those currently existing, creates a great deal of complexity. The credits mentioned above must be claimed in a specific order. In addition, the child tax credit, child and dependent care credit, the education credits and the earned income tax credit are each subject to different income phase outs. These phase outs are equivalent to marginal rate increases and require a taxpayer to perform additional calculations on a separate worksheet, rather than simply entering a standard credit amount on a tax form. The combination of these credits, along with exemptions and deductions, can also cause unintended consequences and major difficulties for taxpayers if they become subject to the Alternative Minimum Tax (AMT).

Again, I am not proposing that we should or should not employ targeted relief or incentives. Rather, I am suggesting that this type of legislation increases the complexity of the tax laws. You must weigh the desire for simplicity against the policy reasons for the legislation. Going forward, you can correct existing complexity by looking at the provisions as a whole to ensure that they are harmonized to the extent possible. You can take steps to minimize the burden taxpayers experience in taking advantage of relief they expect from the laws that you passed.

III. OTHER ISSUES

The next panel intends to raise with you some very specific areas in which you can reduce complexity. I would like to mention very briefly a couple of places in the tax code that could benefit from your attention.

While the subject of AMT is a popular one in tax circles, the AMT itself is not. As I pointed out before, taxpayers Congress never intended to subject to the AMT are and will increasingly be subject to the AMT. This means having to calculate their taxes twice, once under the standard rules and once under the AMT rules. That means taxpayers must understand the basics of the two regimes. Considering that taxpayers can be intimidated by preparing their returns under the one, more common, set of rules, I cannot imagine that subjecting more of them to the AMT will increase their comfort or compliance level.

I also believe that the penalty and interest regimes are unnecessarily complex and, as a result, misunderstood by taxpayers. With regard to the complexity of the regimes, I am confident that the RRA 98 studies on penalties and interest will provide you a roadmap for improving this tool of tax administration. With regard to taxpayers' grasp of the interest provisions, I think that the RRA 98 provision requiring the IRS, beginning in 2001, to provide taxpayers with interest computations and Internal Revenue Code citations imposing the interest will help taxpayers better comprehend their tax situations.

CONCLUSION

Mr. Chairman, there is no more appropriate day than today to discuss our tax laws and the effect of our laws on taxpayers. It is my hope that you will take up the difficult task of reducing complexity. If not, I recommend that you not add to the complexity and slow down the frequency of change to the tax laws.

PREPARED STATEMENT OF GREGORY L. STEINBIS, EA, CPA

Mr. Chairman, Members, staff and guests, my name is Gregory H. Steinbis and I am an Enrolled Agent and CPA engaged in private practice in Morgan Hill, California. I have been an Enrolled Agent for more than 14 years and work with scores of individual and small business taxpayers each year.

As President of the National Association of Enrolled Agents, I am very pleased to have this opportunity to present testimony on behalf of NAEA's Enrolled Agents, all of whom are tax practitioners and the majority of whom are also small business owners.

As you know, Enrolled Agents are licensed by the U.S. Department of the Treasury to represent taxpayers before the Internal Revenue Service. Enrolled Agents, along with attorneys and CPAs, are governed by Treasury Circular 230 in our practice. Enrolled Agents were created by legislation signed into law by President Chester Arthur in 1884 to remedy problems arising from claims brought to the Treasury after the Civil War. Today, we represent taxpayers at all administrative levels of the IRS and provide tax preparation assistance, thereby affording us a front-line perspective on the administration of our nation's tax laws. There are approximately 35,000 Enrolled Agents, about 10,000 of whom are members of NAEA.

On behalf of my Enrolled Agent colleagues, I would like to express appreciation to the Chair, to the Committee members and staff for providing an opportunity for tax practitioners such as Enrolled Agents to provide their views on tax law complexity.

As you may know, NAEA has been a leader in technology by providing online services to our members. At the current time, roughly half of our 10,000 members receive information online. We also survey our members regularly and did a survey on tax law complexity in preparation for this hearing. Although it is the height of filing season, we received scores of replies to our request for information on what was happening in their offices. I would like to share their comments with you:

OVERALL TAX LAW COMPLEXITY

Many of our members noted that their business had increased 10%, 20%, and even 30% this year and attributed much of this to new provisions in the tax code with which taxpayers were unfamiliar. Having tried to "do it themselves," they quickly resolved to let a tax professional handle their returns. Following are some typical comments:

> "I have many new tax clients this year because people who used to prepare their own returns are confused by the new laws. Everyone who has qualified for the child tax credit is surprised and pleased. To sum it up, the new tax law has increased my practice."
>
> "The complexity of the laws were not the problem this year. It was the clients' lack of understanding of them that took more time. This misunderstanding or ignorance of the clients brought in more business than any of us are able to prepare for. We have adjusted and lost more sleep that we usually lose during tax season but the end is still two weeks away . . oh, happy day!"
>
> "I am beginning to wonder if anyone is preparing their own tax return! Our clientele has increased about 30% and most of them have one of the above issues [AMT, child credit, education credits, phase-outs]. Taxpayers are afraid that they will not get it correct and in turn get audited. These new credits are extremely confusing for the average taxpayer. In fact, they are confusing for many tax preparers."

And speaking of tax preparers:

"All in all, this year has been a lot tougher in figuring out the laws and all the changes. Yet, I did spend hours in update seminars, home study, etc., . . what is scary [to consider] is what about those tax people who don't do continuing education. Yikes!"

"I find that many people who cannot afford to have their taxes done have to go to a professional because the forms are too confusing. Example: A young woman made $11,500 on a W-2 plus had $3,000 in 1099 SE income. She thought she could file an EZ form because the Form 1040EZ instructions did not clearly state that she could not use this form if she had received income reported on a Form 1099. She just thought all her income was wages and was eligible. We had to amend her Form 1040EZ and she had to pay a fee for us to assist her. At $14,500 in income, she can barely afford to eat let alone pay for our services."

"My returns are more expensive to the client because of all the new laws: Roth conversions, education credits and again, this year, Schedule D [calculation of capital gains]. One of the most trying things I do is attempt to explain to old-timers who must take money out of IRAs that their Social Security tax is increased a lot. This is very confusing and frustrating to the client . . ."

"This year's complexities have made it much more difficult to explain the tax return to my clients and those people who prepare their own returns and bring them to me for electronic filing have made even more errors than in past years—education credits and child tax credits especially. I have corrected many returns that were self-prepared and turned an e-file return into a prep fee. The biggest surprise seems to be when I ask people about the education credit information!"

In addition to the difficulties of explaining complex tax provisions to taxpayers, some of our members are so overwhelmed that they are literally turning clients away. It is a problem affecting both working poor and affluent taxpayers.

[Tax law complexity] "has so seriously affected my practice that I stopped taking any client who may be due the Earned Income Tax Credit. I returned their papers to them and requested that they go elsewhere to get their tax return done. The reasons: The risks of [the paid preparer] penalty in erroneously designating a child as qualified' when the parent(s) is/are divorced, legally separated, living apart, cohabiting with someone other than the spouse make the determination too risky. Add to this that the taxpayer could have been previously excluded from the EITC and I might forget to ask, or he/she might not tell me or might falsely advise me or not know themselves that they were excluded. Add to this the requirement to ask a client to sign an EITC statement that is incoherent to any average American reader and make me keep that statement on file is all just too much. I have opted out of EITC all together.

"Likewise, I returned the papers of an established client and advised her that I could not do her tax return because of the complexity—impossibility?—of determining the basis of stock her grandfather is giving her and which she is redeeming to cover her college costs. The grandfather has acquired and owned the stock in question for many years. Some, but not all, of the dividends were reinvested. The stock split multiple times over the years. As a sole practitioner, I do not have the time to figure out the basis of the stock as a gift to this woman AND THEN as a capital gain to her as she redeems it. I do not know what solution she found. But I do not believe it is possible for a tax professional (or even the IRS) to accurately compute her capital gain. The rules are impossible to meet."

ALTERNATIVE MINIMUM TAX

So far, we have received only a handful of comments about the AMT and its impact on middle income taxpayers. However, our members are beginning to see it emerge as an issue. Typical is the response of one member, "AMT [is] not a big problem for me this year, but if education/child tax credits trigger it in the future, it will be."

Those members with larger practices and clients with more complex returns are already seeing the issue, including a small business owner who had to file for bankruptcy when an expected refund did not come through because of the AMT. Other Enrolled Agents report that while they have not yet had clients affected by the AMT, in a number of instances they are having to do the extra calculation to make certain they are not affected by it.

IMPACT OF PHASE OUTS

One of the most difficult conversations our members have had with their clients has surrounded the phase outs. At times, the circumstances have been difficult and even heart-breaking:

"Most of our clients make $50,000 to $100,000. In Atlanta, Georgia, these are considered middle income taxpayers. I have found that most of the tax breaks' are not for the middle income' taxpayer. For example: A couple adopted a little girl from Russia. They spent $21,500 over the course of the year and because of their income, they were limited to $2,250 of the $5,000 adoption credit. People with lesser incomes cannot afford to adopt. Therefore the credit is not that helpful if those who can afford to adopt do not get full benefit of the credit. In my opinion, there should be no phase out of the adoption credit. Better for these children to be in a loving [home] environment versus an orphanage."

"Student loan interest for the majority of my clients has been phased out. Again, this really seems unfair to the middle income taxpayer. These people are generally the ones who do not qualify for free' education grants and therefore have to pay for education. The low-income taxpayer can go to school on Pell grants and with public assistance they do not need a deduction because they do not incur debt."

"I have not had one person qualify for the student loan interest [deduction] because of the income limitations."

Another member offers this suggestion:

"Let's have a uniform definition of low income and/or middle income and have the same phase outs for all credits, IRA limits, etc. for all within a given bracket."

Tax practitioners are placed in the unenviable position of having to tell clients they are ineligible for tax credits they thought they would get:

"Clients come in expecting to be eligible for the child tax credit, yet they aren't aware that the child needs to be 17 or younger. . .Several clients are paying tuition for their children and themselves but are over the income limits or are in the phase out brackets, and I have to explain how the phase out works."

"I had several middle class taxpayers who were severely disappointed they could not get the tuition interest deduction or the education credit because they make too much. The bitterest situations were where husband and wife work and made too much income to get the child credit. The most difficult situations arose where taxpayers made Roth conversions but were unknowingly ineligible to do so and their transactions had to be reversed . . .These so-called targeted credits and deductions' are building taxpayer resentment and make for client mistrust of the tax practitioner," warns another Enrolled Agent.

EDUCATION CREDITS AND OTHER EDUCATION SAVINGS INCENTIVES

We received numerous comments on the education credits and related incentives. A representative sampling follows:

"The education credits this year have really been a royal pain . . . the phase out for married filing jointly has impacted the majority of my clients whose children go to big bucks schools. The clients who qualify for the credit usually don't get it because they have qualified for financial aid and therefore did not pay much for schooling. Trying to explain why we can only take the tuition and fees for those courses paid after July 1998 has made life miserable, especially for those clients who qualify and paid for the tuition early. [I am] trying to decide which is better—the Hope or the Lifetime Learning Credit—for those who straddle the qualifying time frame.

"I feel most schools did a great job in letting the students know they took classes and some of the schools even gave us qualifying payments. This only confused the taxpayer as to what this form meant and brought in more new clients."

From another perspective:

"Colleges are giving tuition forms to the students but are not filing them out!! Nine out of 10 are blank. There is a great deal of confusion about education credits and payment for education because of the myriad of programs that colleges have for the payment of school fees. Also, state plainly how many hours or credits constitute half-time!"

"Many clients do not qualify for the education credits because of the income limitations. In my area it is not uncommon for married taxpayers who both have a job to earn over the threshold. It takes both of them working to afford to send the kid to college but then their income disqualifies them for the student loan [interest deduction], education credits, etc. The divorced parent who does not claim the dependent but pays for the education is disqualified from getting the credit. I had one father who had bought the education bonds when they first came out so that he could save for his daughter's education. He cashed them this year when she started school, but since the decree states the wife get the exemption, he had to pay on the savings bond interest. Nor did he get the college credit as she wasn't his dependent but he did help with her schooling."

CHILD CREDIT AND CHILD CARE CREDIT

Comments were both pro and con on the value of the child credit and dependent care credit used for children.

"The child tax credit seems to be doing the most good for my client base . . . I would like to see an increase for child care credits because the cost of day care has dramatically risen, and most families need to have two people working today to make ends meet."

"The guys in the middle are always taking a tax hit so those with the children qualifying for the additional credit are in for a treat. Higher tax bracket folks get hit with the phase outs and of course, don't like missing opportunities available to others."

However, complexity continues to be a problem.

"Last December I got together with three other EAs in the area to work out the child credit by hand so that we would have a good understanding of how the credit worked. We found it quite frustrating to figure using the different worksheets. First of all, it wasn't clear in the instructions we had where you were to start. It would be extremely hard for a person on their own who is not families with tax language to know where to start and what other figures are needed, [for example] they needed to know what FICA tax is. Then, if they are receiving an Earned Income Credit, this also figures into the calculations.

"This all takes time and if they are having a professional help them because they cannot figure it out on their own, it increases the cost of having their taxes figured for them. Most of the people who qualify for these great benefits are on a low pay scale and do not have the education or background to figure this out on their own."

"Talking about unfair, the child care credit limitations have been at $2,400 and $4,800 since the 1970's. Most full time working mothers who have preschoolers pay a minimum of $600 a month for child care here."

"What I am most interested in is the effect of legislation on the so-called dead-beat dad' problem. When the 1986 tax law gave the child exemption solely to the custodial parent and when in 1994 the welfare reform act beefed up the power of states to collect child support from dead beat dads, many of my clients went into the nonfiling subculture. . . . Now the child tax credit, the education credit, the credit for dependent care, and the earned income credit are available to the custodial parent only. It appears that an incentive has been built into the tax law to encourage divorce [along with] a disincentive to come clean with back child support. When in fact in many instances, over half of child support is being provided by the noncustodial parent, there are no tax incentives to encourage keeping up with child support payments. As a matter of social policy, on the one hand, welfare reform has created a large "stick" while tax policy has created a severe disincentive to pay over child support."

And here's the other side of the coin:

"I have had a few situations this year concerning separated or divorced women with a couple of children, getting little or no help from the fathers. [They are] earning $12,000 to $16,000 a year, paying mortgages and attempting to be at home for their children. In one case, my client inherited some money from her mother to be put away for the children's college. In another case, there was a divorce settlement involving a small piece of property and the woman was saving hard to buy a small house. In each case, because the funds were so well managed last year, investment income exceeded $2,300 by a few dollars. The families lost the much-needed Earned Income Credit. We are now in the process of moving the funds out of their names which poses yet other problems. There must be a better way."

IRAS AND RETIREMENT PLANS

Predictably, members report having clients who rolled their IRA into a Roth but then found their income too high to qualify and now are rolling them back into traditional IRAs.

"The Roth rollover and conversions and nondeductible contribution of IRAs has taken more time explaining to clients than actually figuring out what they owe and where to report it. . . ."

"The complexity of the tax law has ranged from confusion about what education expenses are deductible to indecision on the part of taxpayers about whether to contribute to a Roth IRA at the time of tax preparation. Since this is reportable, many returns have been held up since there is no deductibility of the contribution but the contribution must be reported."

"Another serious complexity issue surrounds the entire subject of retirement plans. Plans, regulations, exceptions, contribution limits, thresholds, restrictions, phase-outs, roll-over rules, transfer rules, inheritance rules, excess contribution issues, plan years, Form 1099-R errors, discrimination rules, basis determination errors, Roth vs. Traditional IRA, recharacterization rules, excess accumulation rules—all this and more, put the practitioner in the unenviable position of having to deal with the retirement plan trustee, the investor/custodian, the taxpayer, and the IRS at the worst possible time of the year and after the damage may have already been done. It is way beyond the ability of the taxpayer to understand these rules and issues. So they ask the tax practitioner to do it and of course, the tax practitioner already sees the error, or the damage, and feels obligated to correct it if he can. And of course, the tax practitioner has to take valuable hours explaining to the client what the IRS requires versus what the plan manager did."

"The necessity of keeping information relative to the cost recovery of employee contributions over life expectancy, particularly for municipal public safety personnel. The change from the three year cost recovery rule has made involuntary bookkeepers of these pension recipients who, in most cases, recovered their costs during the second year after retirement and the entire receipt became taxable thereafter. Seems to be an undue burden upon those persons affected for what is certainly not a huge revenue item for the government."

FUTURE PROBLEMS

Will tax complexity end? Probably no time soon. One of our members pointed out that next year there will be a problem with the change in the auto reimbursement rates:

> "Clients usually bring in the mileage figures for the entire year and those who have not been warned will have to go home and break out the figures for the period of 1/1 to 3/31 and then 4/1 to 12/31. We see this problem every year with the client who uses actual figures and buys a new auto. They usually bring the total gas, etc. then we have to break down the expenses per auto."

CONCLUSION

We very much appreciate having had this opportunity to present our views. It is our hope that our comments have provided some idea of the tax law complexity faced by taxpayers and tax practitioners alike, along with some solutions to these problems.

Table 1.--Summary of Present Law Individual Tax Provisions With Phaseins or Phaseouts (1999)

Provision	Code section	Applicable range of AGI
Phaseout of exclusion of social security benefits	Section 86	__First tier:__ *Single:* $25,000-various[1] *Joint:* $32,000-various[1] __Second tier:__ *Single:* $34,000-various[1] *Joint:* $44,000-various[1]
"Pease" limitation on itemized deductions	Section 68	$126,600-various[1]
7.5-percent floor on medical deduction	Section 213	Any taxpayer itemizing medical deductions
2-percent floor on miscellaneous	Section 67	Any taxpayer itemizing miscellaneous deductions
10-percent floor on casualty loss	Section 165(h)(2)	Any taxpayer itemizing casualty loss deductions
Phaseout of personal exemption	Section 151	*Single:* $126,600-$249,100 *H/H:* $158,300-$280,800 *Joint:* $189,950-$312,450
Phasein of earned income credit	Section 32	*No children:* $0-$4,530[2] *One child:* $0-$6,800[2] *Two children:* $0-$9,540[2]
Phaseout of earned income credit	Section 32	*No children:* $5,670-$10,200[2,3] *One child:* $12,460-$26,928[2,3] *Two children:* $12,460-$30,580[2,3]

Table 1.—Summary of Present Law Individual Tax Provisions
With Phaseins or Phaseouts (1999), continued

Provision	Code section	Applicable range of AGI
Phaseout of child credits	Section 24	*Single:* $75,000-various[3] *Joint:* $110,000[3]
Partial phaseout of dependent care credit	Section 21	$10,000-$28,001
Phaseout of eligibility for deductible IRA	Section 219	*Single:* $31,000-$41,000 *Joint:* $51,000-$61,000
Phaseout of eligibility for Roth IRA	Section 408A	*Single:* $95,000-$110,000 *Joint:* $150,000-$160,000
Phaseout of eligibility for education IRA	Section 530	*Single:* $95,000-$110,000 *Joint:* $150,000-$160,000
Phaseout of HOPE credit	Section 25A	*Single:* $40,000-$50,000[3] *Joint:* $80,000-$100,000[3]
Phaseout of Lifetime Learning credit	Section 25A	*Single:* $40,000-$50,000[3] *Joint:* $80,000-$100,000[3]
Phaseout of deductibility of interest on qualified student loans	Section 221	*Single:* $40,000-$55,000[3] *Joint:* $60,000-$75,000[3]
Phaseout of exclusion of interest from education savings bonds	Section 135	*Single:* $53,100-$68,100[3] *H/H:* $53,100-$68,100[3] *Joint:* $79,650-$109,650[3]
Phaseout of credit for elderly and disabled	Section 22	*Single:* $7,500-maximum of $17,500 *Joint:* $10,000-maximum of $25,000
Phaseout of adoption credit and exclusion	Section 23	$75,000-$115,000[3]
Phaseout of first-time homebuyer credit for D.C.	Section 1400C	*Single:* $70,000-$90,000[3] *Joint:* $110,000-$130,000[3]

PREPARED STATEMENT OF WILLIAM J. WILKINS

Mr. Chairman and Members of the Committee:

My name is William J. Wilkins. I appear before you today in my capacity as Director of External Relations of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. Accordingly, except as otherwise indicated, it has not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the Association.

As you know, the ABA Tax Section is comprised of approximately 18,000 tax lawyers. As the largest and broadest-based professional organization of tax lawyers in the country, we serve as the national representative of the legal profession with regard to the tax system. We advise individuals, trusts and estates, small businesses, exempt organizations and major national and multi-national corporations. We serve as attorneys in law firms, as in-house counsel, and as advisors in other, multidisciplinary practices. Many of the Section's members have served on the staffs of the Congressional tax-writing Committees, in the Treasury Department and the Internal Revenue Service, and the Tax Division of the Department of Justice. Virtually every former Assistant Secretary of the Treasury for Tax Policy, Commissioner of Internal Revenue, Chief Counsel of the Internal Revenue Service and Chief of Staff of the Joint Committee on Taxation is a member of the Section.

The Section appreciates the opportunity to appear before the Committee today to discuss simplification. On behalf of the Section, I want to thank the Chairman and this Committee for their focus on eliminating complexity in the tax code. We consider this issue to be of the utmost importance, and the Section looks forward to working with all of you in order to accomplish needed change.

SIMPLIFICATION AND COMPLEXITY

The ABA and its Tax Section have long been forceful advocates for simplification of the Internal Revenue Code. In resolutions proposed by the Tax Section and passed by the full ABA in 1976 and 1985, The ABA went on record urging tax law simplicity, a broad tax base and lower tax rates. We have reiterated this position in testimony before the House Ways and Means and Senate Finance Committees on numerous occasions.

In recent years, the Code has become more and more complex, as Congress and various administrations have sought to address difficult issues, target various tax incentives and raise revenue without explicit rate increases. As the complexity of the Code has increased, so has the complexity of the regulations that the IRS and Treasury have issued interpreting the Code. Moreover, the sheer volume of tax law changes has made learning and understanding these new provisions difficult for taxpayers, tax practitioners and Service personnel alike.

The volume of changes, especially recent changes affecting average taxpayers, has created the impression of instability and unmanageable tax complexity. This takes a tremendous toll on taxpayer confidence. This Committee often hears how our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations. Members of the Tax Section can attest to the widespread disaffection among taxpayers with the current Code. The willingness and ability of taxpayers to keep up with the pace and complexity of changes is now under serious stress.

Tax law changes are again under discussion. The Tax Section does not take a position with respect to the wisdom of particular levels of taxation or of particular broad based tax reduction proposals. We do urge, however, that the members of this Committee keep simplification and avoidance of complexity uppermost in their minds as any tax reduction packages are fashioned. Tax relief can be delivered in ways that avoid new, complicated rules such as phase-outs, multiple choice elections, and highly detailed conditions. While simple, broad-based tax reductions may not have the cachet of the newer style, more targeted provisions, they will avoid the layering of new complexity over old. If Congress chooses to reduce taxes, we urge you to do no harm.

To this end, Stef Tucker, Chair of the Tax Section, on behalf of the Tax Section, recently sent to Secretary Rubin a letter expressing our disappointment that the President's budget proposes to add a multitude of new tax credits to the Federal income tax system. Our point in that letter was that, although each credit taken in isolation could be viewed as meritorious, that kind of micro-balancing inevitably leads to the type of tax system that is, in total, overly complex and undeserving of public respect. Particularly in light of the various, complicated provisions added by the 1997 tax act, Congress and the Administration must focus on the cumulative impact of <u>all</u> new provisions sought to be added. We continue to urge that the leaders of the tax legislative process -- including this Committee -- resist the accretion of income tax benefits and penalties that are unrelated to the administrable measurement of annual taxable income and ability to pay.

Mr. Tucker's letter to Secretary Rubin also urged that particularly close scrutiny be given to any proposals that include income phaseouts. These phaseouts have gained popularity in the last two decades, and are responsible for a significant amount of the complexity imposed on individual taxpayers. Phaseouts create the effect of a marginal rate increase as a taxpayer's income moves through the phaseout range, and the effects of multiple phaseouts on the same taxpayer can create capricious results. Phaseouts also blunt the intended incentive effect, because taxpayers cannot predict whether benefits will be available to them. Phaseouts also play a significant role in the creation of marriage tax "penalties," and add to the difficulty in addressing that set of issues. We urge you to resist their continued use in the enactment of additional tax incentives.

We do not claim to have all the answers. The Tax Section will continue to point out opportunities to achieve simplification whenever possible, including several ideas that we will discuss later in this testimony. However, it is also necessary that we point out that simplification requires hard choices and a willingness to embrace proposals that are often dull and without passionate political constituencies. Simplification also requires that easy, politically popular, proposals be avoided if they would add significant new complexity. Simplification -- and preventing greater complexity -- may not garner political capital or headlines, but it is crucial. It requires leadership from the Administration, and from this Committee.

To date, simplification has not achieved the commitment that we believe is required. Too often, other objectives have tended to crowd simplification out as a priority. We urge the members of this Committee to adjust this balance by endorsing simplification as a bedrock principle, and communicating that principle to all involved in the tax-writing process.

To that end, the Congress adopted as part of the IRS restructuring bill a procedure to analyze the complexity of proposals with widespread applicability to individuals or small business. By means of this complexity analysis, the Joint Committee on Taxation will call attention to provisions that could result in substantial increases in complexity, and will suggest ways in which the goals of those proposals can be achieved in simpler ways. We strongly support this increased focus on complexity and urge the members of this Committee to pay heed to the JCT analyses. Only by raising awareness of problems with proposals before they become law will Congress make substantial inroads into the problem.

SPECIFIC PROPOSALS

We would now like to address certain specific areas in which the Tax Section considers the need for simplification immediate. We begin with the alternative minimum tax, which is an area that we believe demands the immediate attention of this Congress. As this Committee is well aware, there is an inherent problem with the individual AMT which, if not dealt with in one way or another, will result in approximately 9 million additional taxpayers becoming AMT taxpayers within the next decade. Many have referred to this problem as a ticking time bomb. Most of these additional taxpayers are not of the type envisioned as being subject to the AMT when it was revised in 1986. Moreover, many of these individuals will not even be aware they are subject to the AMT until completing their returns or, worse, receiving deficiency notices from the IRS. We are continuing to confer with our counterparts at the Tax Division of the AICPA concerning our respective positions on the AMT, and we have found that our two groups are in accord on the importance of addressing the AMT issue promptly.

A. Alternative Minimum Tax

Background

Individuals first became subject to an "add-on" minimum tax in 1969, enactment of which was precipitated by concerns that some taxpayers with significant economic income were paying little or no tax because of excessive investments in tax shelters. This add-on tax ultimately was repealed and replaced with a minimum tax payable to the extent that an individual's AMT liability exceeded his or her regular tax liability. This minimum tax —which eventually morphed into an entirely separate, parallel, tax system — has been modified several times since enacted.

The current law version of the minimum tax generally involves computing AMT liability by multiplying an AMT rate that is lower than the regular tax rate against a tax base that is broader than the regular tax base. Subject to year-by-year exceptions that have been made, most nonrefundable credits cannot be used to reduce AMT liability. This has the effect of making many credits unavailable to otherwise eligible individuals in cases where use of the credit would cause the amount of the regular tax liability to be less than the tentative AMT liability. The AMT rate brackets are mildly progressive, but are not indexed for inflation.

The base for the AMT is an individual's alternative minimum taxable income (AMTI). An individual's AMTI is determined by adding certain "preference items" to taxable income (such as tax-exempt interest on certain private activity bonds and a portion of the amount excluded from regular taxable income on sales of certain small business stock) and "adjusting" the treatment of certain items to eliminate or reduce benefits associated with the regular tax treatment of those items. Some of these adjustments relate to "business" type items—such as the requirement that depreciation be computed for AMT purposes using a separate system that provides for less accelerated depreciation deductions than under the regular tax system. Other adjustments are purely "personal." For example, adjustments for individuals include: (1) disallowing deductions for State and local taxes; (2) disallowing medical expenses except to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI), and (3) disallowing standard deductions and personal exemptions. Other adjustments that affect individuals relate to investment or employment items. For example, (1) miscellaneous itemized deductions are not allowed, and (2) the special regular tax rules relating to incentive stock options (ISOs) are not allowed. Although an individual is allowed an exemption against his or her AMTI, the exemption amount is not indexed for inflation.

Problems with the AMT

As explained below, we believe that there are at least four significant problems with the individual AMT.

First, the AMT no longer is necessary to fulfill its intended purpose. As indicated above, the original AMT was enacted to address concerns that persons with significant economic income were paying little or no Federal taxes due to investments in tax shelters. This reason is no longer compelling in light of numerous changes that have been made to the Tax Code to specifically limit tax-shelter deductions and credits. For example, the Tax Reform Act of 1986 expanded the application of the at-risk rules and enacted rules limiting deductions and credits for passive-activity losses, which greatly reduced shelter opportunities.

Second, the AMT increasingly is affecting an unintended class of taxpayers—middle class taxpayers who are not engaged in tax-shelter or deferral strategies. Studies indicate that the AMT increasingly is becoming the tax system for middle-income individuals. For example, a pamphlet prepared last year by the Joint Committee on Taxation ("JCT") indicates that, by 2008, 19.7 percent of taxpayers in the $75,000 to $100,000 bracket will be paying the AMT and that almost 1.75 million AMT returns will be filed by individuals in the $30,000 to $75,000 bracket. Joint Committee on Taxation, *Present Law and Issues Relating to the Individual Alternative Minimum Tax ("AMT")* (JCX-3-98), February 2, 1998. Another study indicates that, by 2007, almost 95 percent of the revenue from AMT preferences and adjustments will be derived from four items that are "personal" in nature and are not the product of any tax planning strategies — the personal exemption, the standard deduction, state and local taxes, and miscellaneous itemized deductions. In fact, the same study indicates that, in 1994, the disallowance of the deduction for state and local taxes accounted for approximately 47 percent of total AMT preferences; we expect this percentage is even larger today. Harvey and Tempalski, "The Individual AMT: Why It Matters," *National Tax Journal*, Vol. L, No. 3, September 1997. Further, even those individuals who ultimately do not pay any AMT liability increasingly will lose the benefits of credits that Congress decided were necessary and appropriate and, in some cases, may have been targeted to specific classes of taxpayers. For example, the 1998 JCT pamphlet projects that, by 2008, 7.9 million returns will receive zero or less than the full child care credit due to AMT limitations.

Third, the AMT is too complex and imposes too great a compliance burden. The existence of the AMT system literally requires all people to compute their taxes under two different sets of rules —the regular rules and the AMT rules. Given the complexity associated with the regular tax system, even a small amount of additional complexity from an additional tax system may be too much. However, the AMT involves more than a small amount of additional complexity. Even individuals who ultimately do not end up paying the AMT have to perform calculations to determine whether or not they need to pay it or whether they are restricted in their use of credits. For example, taxpayers trying to determine whether or not they owe the AMT must complete a 12-line worksheet first, then a 43-line form (and another 22-lines if they have long-term capital gains). Further, some of the adjustments (such as those for depreciation and net operating losses) require the taxpayer to keep two sets of records, one for regular tax purposes and the other for AMT purposes so that proper alternative calculations may be made in the future, even if there is no AMT liability currently. It is no wonder that many individuals fail to make the statutorily required calculations, either because they cannot imagine the AMT would apply to them, or because they simply cannot deal with the excessive complexity.

Fourth, some of the adjustments and preference items are inappropriate from both a policy and a technical perspective. While virtually all of the adjustments and preferences can be, and have been, sharply criticized from a policy standpoint, two adjustments that apply only to individuals seem particularly inappropriate for technical reasons as well. Neither the adjustment to disallow miscellaneous itemized deductions nor the adjustment for ISOs seems supportable from a policy or technical standpoint. The AMT's main purpose is to blunt the use of tax shelter or uneconomic deductions incurred to reduce income tax excessively. The regular tax system permits as a miscellaneous itemized deduction those expenditures that are employment related or are clearly related to the production of income or the management or maintenance of income-producing property. There is no AMT objective to deny a deduction for the remaining, clearly employment - or income-related, expenses. Certainly they are not the sort of deductions that individuals incur as tax-shelter items or "trump up" artificially to eliminate income tax.

The AMT system also denies regular tax benefits accorded to incentive stock options by requiring that the excess of the fair market value of the stock over the exercise price (*i.e.*, the "bargain" element) be included in income in the year the option is exercised. However, this adjustment improperly taxes the ISO gain at a 28% rate rather than the top capital gain rate of 20%, the rate applicable under the regular tax system. There seems no justification for this denial of capital-gain character of the bargain element now that Congress has expressed its intention in the Taxpayer Relief Act of 1997 that long-term capital gain be taxed under the AMT system at no higher rate than under the regular system.

Recommendations

We respectfully suggest that the Committee consider the following alternatives, which we state in our order of preference.

1. Repeal the individual AMT. As indicated above, the individual AMT no longer is necessary to serve its intended purpose and, if kept in place, will become the regular tax system for more and more individuals. Further, the additional burdens it imposes are not justified by a sufficiently clear policy objective and, if left unchecked, almost certainly will engender further dissatisfaction with the tax system. We realize that repealing the individual AMT is expensive and may raise a political problem if repeal is perceived as aiding people with economic income to avoid paying their fair share of taxes. However, we respectfully submit that, even though it may be expensive to repeal the individual AMT in its entirety now, the cost of repeal will only increase in the future as more people are affected. Further, it is doubtful that repealing the individual AMT will result in a significant "perception" problem akin to that which precipitated the enactment of the original add-on tax in 1969, given the reforms to the Tax Code that have been made in the interim and Congressional willingness to legislate against shelter transactions in general. Indeed, we believe there will be a much worse political problem if the AMT is not repealed and more and more

Americans become subject to the AMT, lose credits to which they otherwise would be entitled, or are forced to endure the frustration of spending even more time and effort on filing their income tax returns.

2. Exclude taxpayers with average AGI below a certain threshold from the AMT system entirely. In the Taxpayer Relief Act of 1987, Congress struck a blow in favor of simplicity by excluding certain small corporations from the burden of AMT calculations. This was done on the basis of the average gross receipts of the corporation for the prior three years. Applying a similar approach to individuals could exclude many taxpayers from the individual AMT system while still retaining much of the revenue. For example, based on income distribution tables as of 1994, it might be possible to exclude approximately two-thirds of taxpayers from the AMT system, while retaining nearly two-thirds of the revenue, by excluding entirely from the AMT system any individuals whose average AGI for the prior three years was under $200,000, adjusted for inflation. *See* Harvey and Tempalski, Table 3 at p. 463. We emphasize, however, that this approach alone does not fully respond to the significant substantive problems with the AMT.

3. Partial repeal. Another alternative would be to examine each preference and adjustment item separately and to determine whether it should be retained in the AMT system. However, in our view, proper analysis of each item of adjustment and preference would result in the AMT system being repealed. There is little, if any, justification for the "business" adjustments and preferences, and clearly is no justification for any of the personal adjustments and preferences. Still, if full repeal is not possible, major simplification could be achieved by (1) allowing all credits to reduce the individual's liability, without regard to the AMT (i.e., making the temporary measure for 1998 returns permanent); (2) removing most of the adjustments and preferences, which are mostly "cats and dogs" anyway, while retaining at most the four or five "core" items that account for almost all the revenue; and (3) removing some of these core items depending upon revenue constraints. As indicated above, however, we strongly urge the Committee to consider repealing the entire system. Individual items can be addressed directly under the regular tax rules, if necessary for revenue purposes.

4. Fix problems with the existing adjustments and preferences. Even if Congress decides to retain all or most of the existing preferences and adjustments for perception or revenue reasons, we recommend that Congress correct the glaring problems with two preference items that affect only individuals. First, the denial for AMT purposes of any deduction for miscellaneous itemized deductions should be repealed. The regular tax system already denies a deduction for a portion of those expenses, *i.e.*, the portion equal to two percent of AGI. The remaining portion is either an employment-related expense or is clearly related to the production of income or the maintenance of income-producing property. It cannot be said that these deductions are "excessive," uneconomic or otherwise incurred primarily to reduce income tax. There is no reason for these items to be denied under the alternative system when they are sufficiently "income related" to be allowed under the regular tax system. Second, the adjustment for ISO stock should be modified or eliminated as it inappropriately taxes a portion of the gain at a rate in excess of the maximum 20% that Congress intended be applied to long-term capital gain. As noted earlier, because the entire gain will be treated as capital gain if the stock is held for more than 12 months after the option is exercised, the so-called bargain element should also be treated as capital gain under the AMT system and taxed at a top rate of 20%.

5. Index the rate brackets and the exemption amount. Studies have shown that

indexing the rate brackets and exemption amount would solve a significant part of the second problem highlighted above — that more and more people will be affected by the AMT each year. For example, the above-cited article by Harvey and Tempalski indicates that, if the AMT exemption, the income level at which the phaseout of the AMT exemption begins, and the income level at which the AMT marginal rate switches from 26 to 28 percent were indexed, approximately 8.2 million fewer taxpayers would be affected by the AMT in 2007 than if nothing were done. Indexing the parameters of the AMT is less optimal than full repeal, however, because it will do little to alleviate the compliance burden associated with the AMT system. That is, people will still have to make the calculations to determine whether they must pay the AMT or whether they will lose the benefit of certain credits. For these reasons, we view indexing as our last choice and as only a partial response to the problem.

We urge this Committee in the strongest possible terms to solve the problems with the AMT once and for all. There is universal acknowledgement that the effects we have described are unintended and unjustified. It is also acknowledged that the revenue cost associated with a permanent solution will only increase over time and may eventually become prohibitive. It would be a travesty if a permanent solution to the AMT became caught on the merry-go-round of expiring provisions. A permanent solution should not be deferred merely because it competes with other, more popular proposals for tax reduction.

B. Phaseout of Itemized Deductions and Personal Exemptions

At the urging of the Tax Section, the American Bar Association at its February Mid-Year meeting adopted a recommendation that the Congress repeal the phaseout for itemized deductions (the so-called Pease provision) and the phaseout for personal exemptions (the PEP provision). The ABA also recommends that the revenue that would be lost by repeal be made up with explicit rate increases. This would address any revenue neutrality concern as well as any concern with respect to the distributional effects of repeal.

It may be difficult for members of Congress to appreciate the level of cynicism engendered by these two phaseouts. Countless times, taxpayers who might not otherwise be troubled by the amount of tax they are paying have reacted in anger when confronted with the fact that they have lost – either wholly or partially – their itemized deductions and personal exemptions. They are no more comforted when told that these phaseouts should really be viewed as substituting for an explicit rate increase. Almost without exception, they react by asking why Congress refuses to impose the additional rate rather than trying to pull the wool over their eyes.

We have no answer to that question. We take pride in the fact that the ABA is willing to recommend a simplification proposal funded by a marginal rate increase on the same taxpayers benefiting from the simplification. We urge this Committee to give serious consideration to the ABA's recommendation.

C. Additional Simplification Proposals

Although the alternative minimum tax certainly causes great complexity in the Code (and its application is much more widespread than ever envisioned) the Code is replete with numerous other provisions, the complexity of which are much greater than the perceived abuse to which the provision was directed or the benefit that was deemed gained by its addition. Furthermore, the Code contains many provisions which at the time of enactment may well have been desirable, but with the passage of time or the enactment of other changes, have truly become "deadwood". However, despite the lack of utility of such provisions (whether in a relative or absolute sense) analysis of the same may well be required either in the preparation of the tax return or in the consummation of a proposed transaction. The elimination of such provisions would greatly simplify the law. The following are examples of such provisions, that when analyzed do not justify their continuation in the law. Obviously, these are but a few such examples, and an extensive analysis of the Code would undoubtedly uncover a legion of the same. We have separated our recommendations into categories for individual, business, and administrative items.

1. Individual Tax Provisions

a. Simplify Phaseouts.

Numerous sections in the Code provide for the phaseout of benefits from certain deductions or credits over various ranges of income based on various measures of the taxpayer's income. There is no consistency among these phaseouts in either the measure of income, the range of income over which the phaseouts apply or the method of applying the phaseouts. Even without the inconsistencies, the phaseouts cause problems. They add significantly to the length of tax returns, increase the potential for errors, are difficult to comprehend, and make it extraordinarily difficult for families to know whether the benefits the provisions confer will be available. The inconsistencies exacerbate these problems, causing inordinate complexity, particularly for taxpayers attempting to prepare their tax returns manually. Simplicity would be achieved by (a) eliminating phaseouts altogether, (b) substituting cliffs for the phaseouts, or (c) providing consistency in the measure of income, the range of phaseout and the method of phaseout.

b. Rationalize Estimated Tax Safe Harbors.

Section 6654 imposes an interest charge on underpayments by individuals of estimated income taxes, which generally are paid by self-employed individuals. This interest charge generally does not apply if the individual made estimated tax payments equal to the lesser of (x) 90 percent of the tax actually due for the year or (y) 100 percent of the tax due for the immediately prior year. The availability and computation of the prior year safe harbor has been adjusted regularly by the Congress over the past decade. Presently, for individuals with adjusted gross income exceeding $150,000, the prior year safe harbor percentage increases and decreases from year to year over a range from 105 to 112 percent. The purpose of these increases and decreases is to shift revenues from year to year within the five and ten year budget windows used for estimating the revenue effects of tax legislation. Congress should determine an appropriate safe harbor percentage and apply that amount for all years, avoiding the complexity the increasing and decreasing percentages bring.

c. Repeal the Two Percent Floor on Miscellaneous Itemized Deductions.

The two percent floor on miscellaneous itemized deductions contained in Section 67 was enacted as a simplification measure intended to relieve taxpayers of recordkeeping burdens and the Internal Revenue Service ("IRS") of the burden of auditing deductions insignificant in amount. Experience indicates that taxpayers continue to keep records of such expenses to determine deductible amounts in excess of two percent of adjusted gross income. Moreover, the existence of the limitation and the need to identify the deductions to which it applies introduces needless computational and substantive complexity to the preparation of tax returns.

d. Increase the Floor for Itemized Deductions for Medical Expenses and Increase the Personal Exemption Amount for Taxpayers 65 or Over.

A deduction is allowed for medical expenses in excess of 7.5 percent of adjusted gross income. Despite the current 7.5 percent floor, which limits the deduction to extraordinary unreimbursed medical expenses, the existence of the deduction requires taxpayers to identify medical as compared to personal expenses and to maintain detailed records of the former. An increase in the floor to 10 percent of adjusted gross income would reduce the number of returns claiming the medical expense deduction and alleviate substantiation and audit verification problems and numerous definitional issues. An increase in the floor to a catastrophic level would also likely reduce the number of taxpayers maintaining medical records. The personal exemption amount for taxpayers 65 and older could be increased to offset any adverse effect on elderly taxpayers.

e. Reduce Family Unit Tax Complexity.

A number of provisions make the filing of tax returns and computation of tax liability particularly complicated for low and moderate income taxpayers. Certain provisions necessitate the filing of returns by individuals who would otherwise have no tax liability and no need to file. The complexity of the calculations coupled with definitional issues make it extremely difficult for low and moderate income taxpayers to complete their returns without paid assistance, which they cannot afford. These provisions result in a significant number of adjustments to tax returns, causing considerable administrative difficulties for the IRS in making the adjustments and collecting the amounts due. In addition, the adjustments result in additional liability for interest and penalties on the part of a group of taxpayers that has difficulty satisfying the tax liability, let alone additional sums.

f. Earned Income Credit.

The Earned Income Credit (EIC) contained in Section 32 provides a substantial, refundable tax credit to low income workers, both with and without children. The EIC, as presently designed, creates several layers of complexity.

- The EIC requires many taxpayers to file a return whose income would otherwise fall below filing thresholds.
- The definition of a "qualifying child" under Section 32(c)(3) differs from the definition of a dependent child, and treats foster children differently from biological or adoptive children.
- The AGI tie-breaker rule does not resolve the perceived abuse it targets while its application often incorrectly denies the credit to people who should be eligible, insofar as it does not focus on a clear and reasonable definition of what constitutes a "household".

g. Child Credit.

The Child Credit, contained in Section 24, on account of its multiple calculations and "integration" with the child and dependent care credit, the earned income credit, the alternative minimum tax, and social security tax creates unnecessary complexity for taxpayers who would otherwise be able to file simple returns.

h. Dependent Care Credit.

The Dependent Care Credit, contained in Section 21, is of limited benefit to low income working families because it is not refundable. Further, it does not benefit higher-income working families because the credit rate caps at relatively low income levels and does not reflect the true cost of child or dependent care.

i. Nondeductibility of Child Support Payments.

The treatment of child support payments as a nondeductible expense creates confusion and leads to many noncustodial parents claiming dependency exemptions for children without obtaining the required Form 8332. It places the burden on the IRS to administratively identify and audit such claims, and makes the dependency exemption an element of horse-trading in domestic relations disputes, catching taxpayers in a conflict between state domestic relations orders and federal income tax laws. The disparate treatment of alimony and child support adds the complexity of the tax law to negotiations that are often difficult and unpleasant.

j. Dependency Definition.

The current definition of "dependent" under Sections 151 and 152 is confusing and difficult to administer. In particular, problems arise with regard to the treatment of (1) children of separated or divorced spouses; (2) other "custodians" of dependent children; and (3) "custodians" of disabled or elderly individuals. Further, as noted previously, the definition of a dependent child is not harmonized with the definition of a "qualifying child" under the earned income credit, nor is the concept of "support" identical to the concept of "maintaining a household" for purposes of head of household status under Section 2(b). Finally, foster children are treated differently from biological or adopted children.

k. Simplification Alternatives for Family Status Issues.

Simplification for low and moderate income taxpayers could be pursued at a macro level, with a wholesale revision of the provisions intended to provide benefits to this group of taxpayers, or at a micro level by addressing individual issues described above. On the macro level, replacing "head of household" status, dependent child exemptions, and the child credit with one "mega-" program that provides the economic value of these benefits to taxpayers with children, with the same overall distribution of benefits as under current law could result in significant simplification for low and moderate income taxpayers. Definitions would be coordinated with those utilized in the EIC program. The exemption amount could differ depending on whether the taxpayer is single or married (or married filing separately). With this kind of macro revision, taxpayers would only have to walk through two sets of coordinated rules - the mega-exemption and the EIC.

On a micro level, the following alternatives address particular problems and could significantly reduce complexity in those areas.

- Apply one standard for qualification as a dependent child, qualifying child for purposes of the EIC, and head of household status (if retained) that equates support with the cost of maintaining a taxpayer's household and is based on the child residing in the taxpayer's home for more than half the tax year. Provide safe harbors for taxpayers awarded custody by court order or other agreement. (Taxpayers could check a box signifying the existence of such an order or agreement.)

- Define dependent to include foster children residing in a home for more than half the tax year. In the case of a court order or other official "placement" of the child (e.g., by order of the local Department of Social Services, a child welfare agency, or other placement agency), qualification could be established by attaching a copy of the order to the return or checking a box signifying the existence of such an order. In the case of the informal placement of a foster child, the taxpayer would have to establish residence for more than half the tax year.

- Equalize the treatment of alimony and child support by making child support deductible by the payor and included in income by the payee. This will remove much of the "gaming" involved with duplicate claims for dependency exemptions, the earned income credit and head of household status, and problems arising from state domestic relations orders, since it gives taxpayers who pay child support some tax benefit for their payments. Since dependent exemptions will only be claimed by custodial parents or other custodial individuals, nonworking custodial parents will usually not have to file. Those custodial parents who do file will claim dependency exemptions and other child-related credits.

- Increase the dependency exemption to ensure it reflects the cost of maintaining a home for a child. An increase in the amount of the dependency exemption in conjunction with standard deductions that more accurately reflect minimum cost of living would reduce the number of taxpayers who must file returns.

- Replace the "AGI tie-breaker" rule in the EIC with a definition of "household" that more accurately targets the perceived abuse of two unmarried taxpayers living together and gaming the system.

- Facilitating or mandating advance EIC payments through integration of W-4 and W-5 forms and employee withholding systems would eliminate the need for many taxpayers to file returns.

- Establish a uniform credit rate for the dependent care credit and make the credit refundable so it truly benefits lower income working families.

I. Simplify the Capital Gains Provisions.

The capital gains regime applicable to individuals is frighteningly and unnecessarily complex. As a result of Congressional determinations that some assets are worthier of tax benefits than others and that investment in capital assets should be encouraged but only if the tax benefits affect revenue some time in the future, the Code contains a bewildering variety of rules under which different types of assets are subject to different rates and the rates applicable to long-term gains vary depending on the holding period. This system imposes difficult record-keeping burdens on taxpayers and encourages taxpayers to try to manipulate the system through investments in derivatives, short sales, and similar techniques. In addition, taxpayers holding property acquired before 2001 can elect to have the property treated as if it had been sold on the first business day after January 1, 2001, thereby becoming eligible for the special 18% rate if it is held for another five years. Determining whether to make this election will require taxpayers to make economic assumptions and do difficult present value calculations. While there may be some justification for each item of fine-tuning in this area, their cumulative effect has been to create a structure that is incomprehensible to taxpayers and to the people who prepare their tax returns.

Simplification can take several forms. First, different rates for different types of assets (e.g., collectibles) should be eliminated. Second, different rates for long-term assets held for different holding periods should be eliminated; there is no reason to have a special ultra-low rate for assets held for more than five years. Third, to insure that any benefit is extended to all taxpayers regardless of their tax bracket, the concept of special capital gain rates might be replaced by an exclusion for a percentage of long-term capital gains.

m. Harmonize and Rationalize Education Incentives.

The Code contains a variety of provisions granting taxpayers educational incentives. These provisions include education IRAs, the Hope Credit, the Lifetime Learning Credit, exclusions for employer-provided educational assistance, and interest deductions on student loans. The sheer number of alternatives creates complication. Moreover, the targeting of the provisions makes them particularly complicated and difficult to comprehend. The restrictions on their use can mean that taxpayers unexpectedly find they have lost the benefit of a particular incentive. The education incentives should be harmonized and rationalized so that taxpayers have a simple and clear menu of options from which to choose in planning for educational expenses that yields predictable results.

n. Eliminate Elections.

Many provisions allow taxpayers to elect special treatment. While some elections are necessary and appropriate (*e.g.*, election to be treated as an S corporation), it is often the case that elections and safe harbors, even those enacted in the name of simplification, increase complexity. The availability of an election oftentimes requires taxpayers to make multiple computations to determine the best result, thereby adding significant complexity. For example, the various elections available under recently enacted Section 6015 with respect to innocent spouse relief increase planning and procedural complexity significantly. Likewise, some recent proposals for eliminating or reducing the so-called marriage penalty would effectively require married couples to compute their income twice to determine which approach yielded a lower tax payment. In lieu of providing multiple approaches to the same goal, Congress should develop a single legislative solution to address a specific problem, and should make such a solution as simple and fair as possible.

o. Increase the Estate and Gift Tax Unified Credit

The Code requires the estates of decedents with gross estates in excess of the exclusion amount ($650,000 in 1999) to file estate tax returns. According to the latest published IRS statistics (calendar year 1996), approximately 79,346 estate tax returns were filed that year. Fewer than half of the returns filed (47.5 percent) reported estates that were subject to tax. Of those subject to tax, the largest 14 percent of estates (over $2.5 million gross estate) bore 69 percent of the total estate tax paid. Conversely, the lowest 86 percent of gross estates paid only 31 percent of the total estate tax revenues received ($4.51 billion out of $14.49 billion). In 1997, Congress put in place a gradual phase-up of the exclusion amount to $1 million in 2006, which will eliminate the filing requirements for a substantial number of estates otherwise required to file returns and reduce to zero the tax owed by many of those estates. An additional increase in the unified credit (beyond $1 million) would further relieve an additional significant number of decedents' estates from the burden of filing returns and paying estate tax without a significant decrease in federal revenue. More importantly, such a change would relieve many such individuals during their lifetimes of the burden of estate planning geared toward minimizing their estate tax liability

p. Repeal Sections 2032A and 2057

Section 2032A (enacted in 1976) provides special valuation rules for farms and real property used in a trade or business. Section 2057 (enacted in 1997) provides a deduction for a limited amount of the value of a closely held business. The maximum reduction in the value of a decedent's estate from use of section 2032A is $750,000; the maximum deduction under section 2057 is $675,000 (not taking into account the interaction with the unified credit). The limited benefits provided by these sections, which is limited to a select group of taxpayers, should be contrasted with the substantial complexity they produce. In addition to their statutory and administrative complexity, the provisions encourage extensive tax planning and invite manipulation of ownership interests and asset use.

q. Simplify Transfer Tax Valuation of Minority Interests in Non-Publicly Traded Family-Owned Businesses.

Significant taxpayer planning and government administrative expenses are incurred when a discount is claimed with respect to the value of ownership interests in non-publicly traded business enterprises controlled by a family. Significant simplification could be achieved if the value of stock in a non-publicly traded corporation were deemed to be equal to its pro rata share of all the stock of the same class in such corporation, unless a different value is established by clear and convincing evidence. Under this test, all stock held, directly or indirectly, by an individual or by members of such individual's family will be treated as held by one person. Similar rules would apply to ownership interests in other entities.

2. Business Tax Provisions

a. Simplify the Minimum Distribution Requirements.

Under Section 401(a)(9), qualified retirement plan benefits must be distributed to a participant or his or her beneficiary(ies) within a prescribed period of time that is dependent upon a number of variables, including the identity of the participant's beneficiary(ies) and the circumstances under which benefits are paid. Section 408(a)(6) extends these distribution requirements to IRA benefits. The distribution rules in Section 401(a)(9) complicate the administration of qualified retirement plans and IRAs, and present conceptual difficulties for participants. Moreover, although intended to preclude the unreasonable deferral of benefits, benefits deferred are subject to income taxation upon eventual distribution and may be subject to estate taxation upon a participant's death. The provisions of Section 401(a)(9), other than those dealing with the required beginning date for distribution of retirement benefits, should be replaced with the incidental death benefit rule in effect prior to the enactment of the Employee Retirement Income Securities Act (hereafter "ERISA").

b. Eliminate the Half-Year Age Conventions.

Section 401(a)(9) provides that retirement plan benefits must commence, with respect to certain employees, by April 1 of the calendar year following that in which the employee attains 70½. Section 401(k) states that plan benefits may not be distributed before certain stated events, including attainment of age 59½. Further, Section 72(t) provides that premature distributions from a qualified retirement plan, including most in-service distributions occurring before an employee's attainment of age 59½, are subject to an additional 10% tax. Changing these age requirements to age 70 and age 59, respectively, would simplify plan administration.

c. **Repeal or Modify the Top Heavy Rules.**

Section 416 was enacted to limit the ability of a plan sponsor to maintain a qualified retirement plan benefiting primarily the highly paid. Section 416 is both administratively complex and difficult to understand. Furthermore, under current law, there are limitations on the compensation with respect to which qualified retirement plan benefits can be provided, there are overall limitations on qualified retirement plan benefits, and non-discrimination requirements limit the ability of sponsors to adopt benefit formulae favoring the highly paid. Given the other limitations in the Code, Section 416 adds a layer of complexity to employee plan administration that should be unnecessary.

If Section 416 is retained, the rule attributing to a participant stock owned by a member of the participant's family for purposes of determining whether or not the participant is a key employee should be eliminated. This change would be consistent with the recent repeal of the family aggregation rules under Sections 401(a)(17) and 414(q).

d. Replace the Affiliated Service Group and Employee Leasing Rules.

Sections 414(b) and 414(c) treat businesses under common control as a single employer for purposes of determining whether a retirement plan maintained by one or more of these businesses qualifies under Section 401. Two other Code provisions adopt an aggregation concept as well. Specifically, Section 414(m) generally treats all employees of members of an affiliated service group as though they were employed by a single employer, and Section 414(n) states that, under certain circumstances, a so-called leased employee will be deemed to be employed by the person for whom the employee performs services. No regulations have been finalized under these provisions. They are difficult to comprehend and to apply.

Sections 414(m) and 414(n) should be replaced with provisions explicitly describing and limiting the circumstances under which employees of businesses that are not under common control must be taken into account for purposes of determining the qualified status of a sponsor's retirement plan. and the discretion granted under Section 414(o) to develop different rules should be repealed.

e. Worker Classification.

Determining whether a worker is an employee or independent contractor is a particularly complex undertaking because it is based on a 20-factor common law test. The factors are subjective and given to varying interpretations and no guidance exists on how or whether to weight them. In addition, the factors are not applicable in all work situations, and, in some work situations, the factors do not provide a meaningful indication of whether the worker is an employee or independent contractor. The consequences of misclassification are significant for both the worker and employer, including retroactive tax assessments, imposition of penalties, disqualification of benefit plans, and loss of deductions.

Complexity would be significantly reduced by enactment of an objective test to replace the subjective 20-factor test and making it applicable for federal income tax and ERISA purposes. In the alternative, changes could be made to reduce the differences between the tax treatment of employees and independent contractors. Efforts to make the tax law more neutral with respect to whether a worker is an employee or independent contractor would reduce the importance of the worker classification rules because the consequences of misclassification would be less significant.

f. Expand the Cash Method of Accounting.

Small C corporations, qualified personal service corporations, sole proprietors, and certain passthrough entities are excepted from the required use of the accrual method under Section 448. This exception does not cover more than de minimis amounts of inventory, however, and there are no specific rules delineating when inventory is de minimis. In addition, the applicability of the inventory rules, which were written for the industrial age, is not at all clear for businesses operating in the information age. For example, it is not clear whether a business developing software sold via the Internet is required to use an inventory method. Thus, some businesses cannot easily determine if they have inventory that requires them to use the accrual method of accounting. Moreover, many of these businesses otherwise use the cash method of accounting and requiring the use of the accrual method and the keeping of inventories subjects them to complex rules and recordkeeping.

Considerable simplification could be achieved by amending Sections 446 and 448 to allow small taxpayers to use the cash method of accounting. Consistent with Section 448, small taxpayers (even those with inventory) could be defined as those with average annual gross receipts in the three prior years of $5 million or less. This rule would enable small businesses (even those with inventory) to use the cash method should they find it simpler. This proposal should not result in taxpayers manipulating their income because such businesses generally cannot afford to maintain large quantities of inventory on hand and the inventory levels of small businesses, in particular, would not be extensive. Further simplification could be achieved by increasing the Section 448 gross receipts threshold to $10 million.

g. Provide Clear Rules Governing the Capitalization and Expensing of Costs and Recovery of Capitalized Costs.

Although the IRS has stated the Supreme Court's decision in *INDOPCO v. Commissioner*, 503 U.S. 79 (1992), did not change fundamental legal principles for determining whether a particular expense may be deducted or must be capitalized, since *INDOPCO*, whether an expense must be capitalized has become the most contested audit issue for businesses. A future benefit test derived from the *INDOPCO* decision has been used by the IRS to support capitalization of numerous expenditures, many of which have long been viewed as clearly deductible. Almost any ongoing business expenditure arguably has some future benefit. The distinction between an "incidental" future benefit, which would not bar deduction of the expenditure, and a "more than incidental" future benefit, which might require capitalization, generally is neither apparent nor easy to establish to the satisfaction of parties with differing objectives. In addition, the administrative burden associated with maintaining the records necessary to permit the capitalization of regular and recurring expenditures is significant. Development of objective, administrable tests governing the deduction of expenses or the capitalization of categories of expenditures would significantly reduce controversy, just as the enactment of section 197 significantly reduced controversy regarding the amortization of intangible assets. For example, repair allowance percentages such as those previously provided under the Class Life Asset Depreciation Range (CLADR) System would significantly reduce controversy regarding capitalization of repair expenditures. See Rev Proc. 83-35, 1983-1 C.B. 745 (CLADR repair allowance percentages); see also I.R.C. § 263(d) (repair allowance percentage for railroad rolling stock).

h. Modify the Uniform Capitalization Rules.

The uniform capitalization ("UNICAP") rules in section 263A are extraordinarily complex. Compliance with the UNICAP rules consumes significant taxpayer resources; yet for many taxpayers, the UNICAP rules do not result in capitalization of any significant amounts not capitalized under prior law. Modification of the UNICAP rules to limit their application to categories of expenditures not addressed comprehensively under prior law (*e.g.*, self-constructed assets) or to large taxpayers would reduce complexity for many taxpayers.

i. Simplify S Corporation Qualification Criteria.

The definition of an "S corporation" contained in Section 1361 establishes a number of qualification criteria. To qualify, the corporation may have only one class of stock and no more than 75 shareholders. Complex rules provide that the shareholders must be entirely composed of qualified individuals or entities. On account of state statutory changes and the check-the-box regulations, S corporations are disadvantaged relative to other limited liability entities, which qualify for a single level of federal income taxation without the restrictions. The repeal of many of the restrictions would simplify the law and prevent inadvertent disqualifications of S corporation elections.

j. Modify the S Corporation Election Requirement.

Section 1362(a)(2) requires all shareholders to consent to an S corporation election and that the election be made on or before the 15th day of the third month of the taxable year. There are also election deadlines for qualified subchapter S subsidiaries and qualified subchapter S trusts, which adds complexity. Late elections are common occurrences because taxpayers are unaware of or simply miss the election deadline. If the election is filed late, Section 1362(b)(5) permits the IRS to treat the late election as timely if the IRS finds reasonable cause for the late election. This provision has saved hundreds of taxpayers from the consequences of a procedural mistake; it has also generated considerable administrative work for the IRS as is evidenced by the hundreds of rulings granting relief. The election deadline was intended to prevent taxpayers from waiting until income and expenses for the taxable year were known before deciding whether to make an S corporation election. The differences that exist between the taxation of S and C corporations are so significant, however, that it is unlikely a taxpayer's decision over whether to make an S corporation election would be determined by the events during a single taxable year. Even if that were the case, it is difficult to understand the compelling policy reason to require taxpayers to guess at their financial operations for the year in determining whether to make an S corporation election at the beginning of the year rather than making an informed decision. The ability to pass through losses has been substantially restricted by various provisions of the Code. Thus, concerns about passing through losses are likely more theoretical than real. In addition, as a practical matter, taxpayers cannot wait until the end of the taxable year to make a decision because the need to make estimated tax payments compels a decision before the date the first estimated tax payment is due. Thus, the separate filing of the election itself is a mere procedural requirement leading to frequent procedural foot faults, but little else.

The most obvious time for the filing of an election is with a filing that is otherwise required. Significant simplification could be achieved by requiring the election to be made on the corporation's timely filed (including extensions) federal income tax return for the year of the election. The same rule should apply to the qualified subchapter S subsidiary and qualified subchapter S trust elections.

k. Repeal or Simplify the Personal Holding Company Rules.

The personal holding company rules were enacted in 1934 to tax the so-called "incorporated pocketbook." With differentials in the corporate and individual tax rates, individuals could, for example, place their investments in a corporation and substantially lower the federal income tax paid on income generated by those investments, especially if the income was held in the corporation and reinvested for a long period of time. The personal holding company provisions attack this plan by imposing a surtax on certain types of passive income earned by closely held corporations that is not distributed (and thus taxed) annually.

Over time, the personal holding company rules have been broadened to include many closely held corporations, both large and small, with passive income (whether or not such corporations are, in effect, an "incorporated pocketbook") and, thus, may create a trap for the unwary. In addition, the rules have become very complex and difficult for the IRS to administer and for taxpayers to comply with, and sometimes require taxpayers to rearrange asset ownership to comply with the rules. With maximum corporate and individual rates coming closer together and the repeal of General Utilities, it is questionable whether the personal holding company rules should remain in the tax code at all. Regardless of this debate, however, the rules should be significantly simplified in order to eliminate the substantial burden they impose on closely held corporations.

l. Repeal the Collapsible Corporation Provision.

Since the repeal of the General Utilities Doctrine in 1986, Section 341, the collapsible corporation provision, is essentially deadwood. By definition, a collapsible corporation is a corporation availed of with a view to a sale of stock before a substantial amount of the corporate income has been recognized. After 1986, a sale of corporate stock or a sale of all of a corporation's assets prior to the realization of corporate income cannot escape corporate taxation. Section 384 insures a purchaser of stock of a corporation with built-in gain property cannot utilize its losses to shelter that gain. Since 1964, a corporation could escape the rigors of Section 341 by effecting a Section 341(f) election, *i.e.*, the corporation agrees to recognize gain on the disposition of subsection (f) assets, notwithstanding any otherwise applicable non-recognition provisions of the Code. The repeal of General Utilities renders 341(f) redundant. More accurately, it renders 341(a) redundant because no corporate gain can now escape corporate tax. Since it was that avoidance or potential avoidance that gave birth to Section 341, it is now deadwood and should be repealed. Its repeal would result in the interment of the longest sentence in the Internal Revenue Code – Section 341(e).

m. Simplify the Attribution Rules.

The attribution rules throughout the Code contain myriad distinctions, many of which may have been reasonably fashioned in light of the particular concern of the underlying provision. For example, should siblings be included in the rules? Should the ownership test be 80? or 50%? Whatever the reasons driving the differences among the attribution rules, it is not clear those reasons are not outweighed by the need to simplify the Code. Consequently, the attribution rules and the concerns underlying them should be reexamined in light of concerns about complexity with a view to harmonizing and standardizing the rules unless there are truly compelling reasons to do otherwise. At a minimum, and without reexamination, it is clear the rules could be simplified by standardizing whether the percentage is equal to or greater than and not have both.

n. Simplify the Loss Limitation Rules.

The Code contains multiple rules limiting taxpayers' ability to claim or use losses. Among them are Section 465, which limits the deductibility of losses of individuals and certain C corporations to the amount at risk, that is, generally, the amount of the investment that could be lost plus the taxpayer's personal liability for additional losses, Section 469, which limit losses incurred in "passive activities," Section 704(d), which limits a partner's distributive share of a partnership's losses to the partner's basis in the partnership interest, and Section 1366(d), which limits an S corporation shareholder's loss in similar fashion.

There are numerous limitations and qualifications on each of these rules and definitions, and Sections 465 and 469, in particular, are extremely complicated and difficult to comprehend. Section 465 originally applied only to certain types of activities deemed especially prone to abuse, such as the production and distribution of films and video tapes, but, in 1978, it was extended to virtually all other income-producing activities. Since the enactment of Section 469, Section 465 has become superfluous because there are very few situations in which a deduction would be denied because of the applicability of section 465 that would not also be denied because of the applicability of section 469.

Substantial simplification could be achieved by combining, rationalizing, and harmonizing the loss limitation provisions.

o. Simplify Section 355

Section 355 permits a corporation or an affiliated group of corporations to divide on a tax-free basis into two or more separate entities with separate businesses. Under Section 355(b)(2)(A), which currently provides an attribution or "lookthrough" rule for groups of corporations that operate active businesses under a holding company, "substantially all" of the assets of the holding company must consist of stock of active controlled subsidiaries. Under this rule, holding companies that, for very sound business reasons, own assets other than the stock of active controlled subsidiaries are required to undertake one or more preliminary (and costly) reorganizations solely for the purpose of complying with this provision. Treating members of an affiliated group as a single corporation for purposes of the active trade or business requirement will simplify numerous corporate transactions.

p. Simplify the Consolidated Return Rules.

Affiliated groups of corporations can elect to file a single consolidated income tax return. The dominant theory governing the development of the consolidated return regulations is that the consolidated group should be treated as a single entity. As evidenced by the hundreds of pages of regulations and excruciating detail, this seemingly simple concept has evolved into one of the most complex and burdensome areas of the tax law. These rules, which are laced with numerous traps for the unwary, are virtually incomprehensible, even to experienced tax practitioners if they do not spend an entire career in the consolidated return area. With the advent of single-member LLCs and the check-the-box regulations, many companies may be able to avoid or ameliorate the complexity of the consolidated return rules by simply inserting single-member LLCs into their corporate structure. For companies that desire or are required to use a subchapter C corporation, however, the consolidated return rules still present a major stumbling block in terms of complexity. Accordingly, simplification of the consolidated return rules would be a major step towards the ultimate goal of simplifying the tax laws.

q. Simplify the PFIC Rules.

In 1997, the passive foreign investment company ("PFIC") rules were greatly simplified by the elimination of the controlled foreign corporation-PFIC overlap and by allowing for a mark to market election for marketable stock. However, a great deal of complication remains in the PFIC area suggesting that further simplification is necessary. Considerable simplification could be achieved by eliminating the application of the PFIC rules for smaller investments in foreign companies whose stock is not marketable.

r. Simplify the Foreign Tax Credit Rules.

The foreign tax credit area is subject to significant complication, particularly because of the nine separate baskets for allocating income and credits set forth in Section 904(d)(1). Consolidating these baskets for businesses that are either starting up abroad or that constitute small investments would provide some relief from the complexity. In addition, treating the European Union as a single country would eliminate another complication faced by US taxpayers competing in this newly unified marketplace. Lastly, the elimination of the alternative minimum tax credit limitations on the use of foreign tax credits would greatly simplify this area for all US taxpayers operating abroad without permitting tax motivated behavior.

s. Simplify the Subpart F Rules.

The Subpart F rules present a host of difficulties in their application. While the rules may be necessary to prevent tax avoidance by large and sophisticated taxpayers, smaller taxpayers or smaller foreign investments could be excepted from the application of these rules, which would greatly simplify the tax system, without creating the potential for the tax avoidance the rules were intended to prevent.

t. Clarify Treatment of Check-the-Box Entities for Subpart F Purposes.

Notices 98-11 and 98-35 caused considerable confusion in planning with respect to international tax matters. Notice 98-35 suggests potential rules that, once implemented, could adversely affect the use of so-called "check-the-box" entities (that is, entities that are either disregarded or treated as partnerships for federal income tax purposes but are treated as taxable entities under local law) in international transactions. The suggested rules are leaving many taxpayers with uncertainly in their international planning. Congressional clarification of what factors should be relevant in computing "foreign personal holding company" income under Subpart F would greatly simplify the task of international tax compliance.

u. Repeal Section 514(c)(9)(E)

In general, income of a tax exempt organization from debt financed property is treated as unrelated business taxable income. Debt financed property is defined in Section 514 as income producing property subject to "acquisition indebtedness," which generally does not include debt incurred to acquire or improve real property. Section 514(c)(9)(E) (the "fractions rule") provides, in general, that debt of a partnership will not be treated as acquisition indebtedness if the allocation of income and loss items to a tax exempt partner cannot result in the share of the overall taxable income of that organization for any year exceeding the smallest share of loss that will ever be allocated to that organization. This provision was enacted to prevent disproportionate allocations of income to tax exempt partners and disproportionate allocations of loss items to taxable partners. The provision has become a trap for the unwary as well as a tremendous source of planning complexity even for those familiar with it. Anecdotal evidence suggests that few practitioners understand the provision completely and almost no IRS agents or auditors raise it as an issue on audits. Instead, because of its daunting complexity, it has become a barrier to legitimate investment in real estate by exempt organizations. At the same time, other provisions in the tax law (such as the requirement of substantial economic effect under section 704(b)) substantially limit the ability to shift tax benefits among partners. Therefore, section 514(c)(9)(E) could be repealed without substantial risk of abuse.

3. Administrative Provisions

a. Deposit Penalty.

The failure to timely deposit taxes is subject to penalty, pursuant to Section 6656, in amounts ranging from 2 percent to 15 percent of the underdeposit, depending on the lateness of the deposit. The deposit rules are unnecessarily complex and adversely affect small businesses as they move from one payroll deposit category to another.

For example, professional corporations may be severely impacted where their payroll deposit is normally less than $100,000 per pay period which permits at least semi-weekly deposits (*i.e.*, a three-day deposit rule). However, at each year end, in order to pay out all, or almost all, of the corporation's income, bonus compensation distributions are frequently required. The amount of the bonus distributions for each employee, a prerequisite to determining appropriate withholding tax, cannot be ascertained until the annual books are closed. Closing of the books requires receipts, expenses, etc. for the last day of the taxable year to be considered. Bonuses must also be paid by the last day of the taxable year (often December 31) to be tax deductible for such year.

Financial intermediaries generally require at least one day's advance notice to make electronic federal withholding tax deposits. Banks and taxpayer businesses are frequently shorthanded at year end and find it difficult to determine the amount of the federal tax deposit due until after the financial intermediaries' cutoff time to make withholding tax deposits on the next business day. This is particularly true for taxpayers in the western U.S. time zones. A 2 percent penalty is excessive for a deposit that is only one day late, particularly where the depositor is normally a semi-weekly depositor but is required to make a one-day deposit.

Congress recently recognized that the changing of deposit requirement time frames is a complexity that causes great confusion and that waiver of the penalty should be permitted for the first change period. See Section 6656(c)(2)(B). While this solution helps, it does not fully address the problem. The current provision requires an administrative waiver request that may be expensive and time consuming and applies only to the first instance of a problem which by nature is likely to occur annually. Section 6302 (or the regulations) should be modified to require next day electronic depositing only in those instances where next day depositing (*i.e.*, $100,000 or more deposit) is required of that taxpayer with respect to 10 percent or more of its deposits. Alternatively, taxpayers could be given a minimum of two days to make deposits of $250,000 or less.

b. Information Returns.

Sections 6041 and 6041A generally require reporting of all payments made in connection with a trade or business that exceed $600 per year. The $600 per year has never been adjusted for inflation. Section 6045(f) now requires reporting of all gross payments to attorneys (includes law firms and professional corporations) where the portion constituting the legal fee is unknown even if the payment is less than $600. Many Form 1099 information returns from non-financial institutions cannot be processed by the IRS or do not provide truly useable information. Anecdotal evidence suggests the information on these information returns may not be used in examinations of the taxpayers and cannot be reconciled to tax returns. The reporting threshold should be increased to $5,000 (which harmonizes with Section 6041A(b)) and adjusted for inflation in full $1,000 increments.

c. Penalty Reform

The 1998 IRS Restructuring Act instructs both the Joint Committee on Taxation and the Treasury Department to conduct separate studies of the penalty and interest provisions of the Code and to make recommendations for their reform.

The Tax Section believes that reform of the penalty and interest provisions is appropriate at this time and look forward to working with the JCT and Treasury. There are many cases in which the application of penalty and interest provisions take on greater significance to taxpayers than the original tax liability itself. The Tax Section is concerned that these provisions often catch individuals unaware, and that the system lacks adequate flexibility to achieve equitable results. In light of the significant changes being made by the IRS, the completion of this study and eventual enactment of the recommendations will be welcome.

The Tax Section has submitted preliminary comments to the staff of the Joint Committee on Taxation that we hope will be useful in developing alternatives. We expect to submit final comments and recommendations to both the Joint Committee and Treasury in the late spring.

CONCLUSION

Thank you again for the opportunity to testify at this very important hearing. We would be happy to work with the Committee as it develops any legislation to address the twin tasks of simplification and avoidance of complexity.

COMMUNICATIONS

NATIONAL TAXPAYERS UNION

A Taxing Trend
The Rise in Complexity, Forms and Paperwork Burdens

Statement of
David Keating
Senior Counselor,
National Taxpayers Union

Submitted to the
Committee on Finance
U.S. Senate

April 15, 1999

Like old age, tax complexity has been creeping up on us over the last 20 years. We may not notice it one year at a time, but a review of older tax instructions reveals just how shockingly complicated taxes have become today.

Even though a 1995 law demanded that Federal paperwork burdens be cut by 30% by 1999, rising tax paperwork demands have more than offset cuts in other agencies.

Taxpayers Must Cope with More Forms and Longer Instructions.

A tour of the tax law's complications can begin by looking at Form 1040 over the years. Sixty-four years ago its instructions were just two pages long. Even when the income tax became a mass tax during World War II, the instructions took just four pages. Today taxpayers must wade through 101 pages of instructions, almost double the number in 1985, the year before taxes were "simplified."

Form 1040 — Form and Instructions

Year	Lines 1040	Form Pages 1040	Instruction Booklet Pages 1040
1998	69	2	101
1995	66	2	84
1985	68	2	52
1975	67	2	39
1965	54	2	17
1955	28	2	16
1945	24	2	4
1935	34	1	2

There are 190 commonly used tax forms and instructions this year. The IRS mails these to tax professionals as Package X and sends a similar set to the nation's public libraries. Package X has grown 46% since 1980.

Pages in Package X – Commonly Used Forms and Instructions

1980	611 pages
1998	892 pages

We suspect the growth would be more alarming if 1975 were used as a baseline, but a key IRS Library only has Volume I from 1975, which was a slender 159 pages that year. It expanded to 300 pages in 1980 and 448 pages in 1998.

Package X doesn't even contain all the forms. Many of the forms' instructions do not provide enough information to properly complete the form or comply with the law, so the IRS has various publications to help. Counting the forms, instructions, publications and other sources of help, the IRS makes at least 3,415 documents available in the Adobe Acrobat format on a CD-ROM. The forms and instructions on the CD-ROM reach back to 1991, but many of the publications only go back to 1994 for tax returns filed in 1995.

Just the 1998 products available on CD-ROM span a list 50 pages long, while the list of documents for 1991 to 1997 fills 157 pages.

Paid Professionals Now Prepare Most Tax Returns.

As the tax system's complexity has grown, more taxpayers are running to tax professionals to prepare their returns. The growth in the use of paid preparers can be accurately tracked because since 1977 tax professionals have been required to sign returns they have been paid to prepare.

Tax Returns Signed by Paid Preparers

Tax Year	Paid Preparer Returns (percent)
1980	38.0%
1985	45.9%
1990	47.9%
1992	49.3%
1995	49.9%
1996	53.1%
1997	54.7%

Between 1966 and 1977, anyone who prepared a return was required to sign it in addition to the taxpayer, meaning many unpaid relatives or friends signed the returns. Therefore, the data for the first few years probably overstates paid-preparer participation, because undoubtedly many unpaid people who had signed returns for years kept doing so even after the law had changed.

The number of taxpayers using paid professionals has soared by 44% since 1980 and by 14% during this decade. While some of this increase can be attributed tc rising incomes, the growing use of home computers and tax preparation software has likely curtailed the rush to paid professionals.

Tax preparation software has grown in sophistication as Windows software has come to dominate the PC market, enabling more taxpayers to sit in front of a computer and answer a seemingly endless stream of questions while the computer figures out how to prepare the return.

In 1980 no individual taxpayers used computers to prepare their taxes. Yet today, when accounting for paid preparers *and* computer returns combined, almost 75% of all returns are prepared with such assistance.

Use of Paid Preparers and Computers

Tax Year	Paid Preparer plus Computer Prepared Returns (percent)
1980	38.0%
1996	66.4%
1997	70.5%
1998*	74.1%

* Through March 12

Tax Preparation Fees are Rising Too.

Tax preparation fees have increased substantially, largely due to increased complexity of the average tax return. One way of examining the trend in fees is to examine the average fees charged by H&R Block, a publicly traded company.

H&R Block is the nation's largest tax preparation firm, and alone accounts for about one in seven tax returns filed by all Americans. Since 1985 the average fee has increased 95% in current dollars, or 25% after accounting for inflation.

The rise in fees has occurred despite a huge increase in the capability of tax return software and speed of printers since 1985. The efficiency gain of computers and printers has likely been overwhelmed by the increases in complexity.

Average Fee Charged by H&R Block

Calendar Year	Nominal Dollars	In 1999 Dollars
1985	$45.39	$70.69
1988	$49.21	$69.88
1998*	$79.54	$80.87
1999*	$88.42	$88.42

* Through March 15

New Law Orders Cut in Paperwork, but Tax Paperwork Burden Rises.

In an attempt to bring the paperwork burden under control Congress passed the Paperwork Reduction Act of 1995, which set annual goals for Federal agencies to meet. According to the Office of Management and Budget, the new law "set an annual government-wide goal for the reduction of the total information collection burden of 10% during each of Fiscal Years 1996 and 1997 and 5% during each of Fiscal Years 1998 through 2001. The baseline is the total burden of information collections as of the end of FY 1995."

By that measurement, the law has been a failure, largely due to the increasing burdens at the IRS. Burden hours at all agencies are expected to increase from 6,901 million hours in 1995 to 7,435 million hours in 2000.

Instead of declining by double-digit rates, tax paperwork burdens will soar by about 15% during the five years ending in 2000.

The original Paperwork Reduction Act was passed in 1980 and required Federal agencies to track the paperwork burden imposed on citizens and business by their forms and recordkeeping requirements. In order to comply with the law, the IRS commissioned Arthur D. Little to undertake a comprehensive estimate of tax compliance costs for the tax year 1983, and this survey served as the basis for the methodology used to track tax paperwork burdens that the IRS finalized with the 1988 tax year.

While the Little study is by far the most comprehensive available, James Payne estimated in his 1993 book Costly Returns that even it may understate the real burden "perhaps by about 20-30 percent."

While no figures are separately published for the IRS, tax form paperwork burdens alone account for roughly 80% of the total paperwork burden hours of the United States Government. The IRS is part of the Department of the Treasury and very nearly accounts for the Department's entire paperwork burden.

In Fiscal Year 1999, total paperwork burdens for all agencies are estimated at 7,202.59 million hours, and the Treasury Department accounts for 5,912.44 million of these hours, or 82%.

If the Treasury Department were to reduce its burden by the average amount mandated by the 1995 Paperwork Reduction Act, the burden would decline to 3,702 million hours in 2000. Instead, the Treasury has overshot that target by 2,409 million hours.

Paperwork Burden Hours
Department of the Treasury

Fiscal Year	Burden Hours (in millions)	Paperwork Reduction Act of 1995 Target	Cumulative Increase Since 1995	Compared to Target
1995	5,331.30			
1996	5,352.85	4,798.17	0.4%	554.68
1997	5,582.12	4,318.35	4.7%	1,263.77
1998	5,702.24	4,102.44	7.0%	1,599.80
1999	5,912.44	3,897.31	10.9%	2,015.13
2000	6,111.69	3,702.45	14.6%	2,409.24

Estimated hours for FY 1999 and 2000.
Target hours assume Treasury Department reductions meet the law's overall average reduction for all Federal paperwork.

Paperwork burdens aren't the result of IRS bureaucrats mindlessly dreaming up new forms and regulations. Much of the burden increase is due to a flood of new tax laws, including the Taxpayer Relief Act of 1997. That law did reduce tax bills for middle class taxpayers, but significantly increased their paperwork burdens. As of December 1998 the 1997 Taxpayer Relief Act alone added an estimated 92 million hours to the paperwork burden.

These figures apparently only account for the time spent in keeping the necessary records and learning about and complying with the law. Yet a significant additional but uncounted burden comes from trying to exploit the law's loopholes to the maximum extent. For example, millions of citizens subscribe to personal finance publications and much of the advice offered deals with taxes. Taxpayers are often advised to consider the tax consequences of any major financial transaction, and this form of tax planning undoubtedly adds many millions of hours to the time spent coping with the tax system.

It's Taking Longer to Prepare and File Tax Returns.

Despite the passage of the 1995 Paperwork Reduction Act, the time it takes to file commonly used individual income tax forms has increased.

The 1040 form is often filed with Schedules A, B and D where taxpayers report itemized deductions, interest and dividend income, and capital gains, respectively. From 1988, when the IRS started tracking this information, to 1998, the average paperwork burden hours climbed from 17 hours and 7 minutes to 23 hours and 55 minutes, an increase of 40%. The time burden has increased by 13% since 1995.

History of Estimated Preparation Time, 1040 Form and Common Schedules

Year	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
Form 1040 and Schedules A, B & D					
1998	7:50	5:17	8:53	1:55	23:55
1997	7:04	4:10	6:44	2:08	20:06
1996	7:04	4:14	7:01	2:08	20:27
1995	7:04	4:36	7:11	2:21	21:12
1994	7:04	4:09	7:09	2:21	20:43
1993	7:04	4:08	6:29	2:28	20:09
1992	7:04	4:11	6:11	2:18	19:44
1991	7:04	3:59	5:56	2:09	19:08
1990	7:04	4:04	5:26	1:50	18:24
1989	6:56	3:58	5:19	1:30	17:43
1988	6:56	3:39	5:02	1:30	17:07
Form 1040 only					
1998	3:34	2:25	4:55	0:40	11:34
1997	3:08	2:07	3:59	0:40	9:54
1996	3:08	2:32	4:33	0:40	10:53
1995	3:08	2:54	4:43	0:53	11:38
1994	3:08	2:53	4:41	0:53	11:35
1993	3:08	2:47	3:44	0:53	10:32
1992	3:08	2:42	3:37	0:49	10:16
1991	3:08	2:31	3:23	0:41	9:43
1990	3:08	2:33	3:17	0:35	9:33
1989	3:07	2:32	3:10	0:35	9:24
1988	3:07	2:28	3:07	0:35	9:17

Even the short forms are becoming more complicated. The 1040EZ form, the simplest in the IRS inventory, now requires 2 hours and 47 minutes, up from 1 hour and 31 minutes in 1988, a jump of 84%. The 1040A and Schedule 1 (interest and dividend income) has seen a paperwork burden increase of 17% since 1995.

The tax code is so convoluted that no one inside or outside the IRS understands it. For many years *Money* magazine's annual test of tax preparers proved that paid professionals often make huge mistakes. Last year all forty-six tested tax professionals got a different answer, and not one got it right. The pro who directed the test admitted

History of Estimated Preparation Time, 1040A and 1040EZ Forms

Year	Recordkeeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
Form 1040A and Schedule EIC					
1998	1:17	2:31	4:05	0:55	8:48
1997	1:04	2:10	3:08	0:55	7:17
1996	1:04	2:32	3:29	0:55	8:00
1995	1:04	2:25	3:02	0:40	7:11
1994	1:03	2:16	2:55	0:40	6:54
1993	1:42	2:24	3:17	1:22	8:45
1992	1:42	2:24	3:20	1:22	8:48
Form 1040A and Schedule 1					
1998	1:37	2:33	4:11	0:55	9:16
1997	1:24	2:12	3:14	0:55	7:45
1996	1:24	2:34	3:35	0:55	8:28
1995	1:24	2:27	3:08	0:55	7:54
1994	1:23	2:18	3:01	0:55	7:37
1993	1:23	2:12	2:54	0:55	7:24
1992	1:23	2:12	2:57	0:55	7:27
1991	1:23	2:15	3:01	0:55	7:34
1990	1:42	2:35	3:26	0:55	8:38
1989	2:07	2:20	3:33	1:10	9:10
1988	1:53	2:16	3:12	1:10	8:31
Form 1040A only					
1998	1:17	2:29	4:01	0:35	8:22
1997	1:04	2:08	3:04	0:35	6:51
1996	1:04	2:30	3:25	0:35	7:34
1995	1:04	2:23	2:58	0:35	7:00
1994	1:03	2:14	2:51	0:35	6:43
1993	1:03	2:08	2:44	0:35	6:30
1992	1:03	2:08	2:47	0:35	6:33
1991	1:03	2:11	2:51	0:35	6:40
1990	1:22	2:31	3:16	0:35	7:44
1989	1:21	2:13	2:56	0:35	7:05
1988	1:20	2:11	2:52	0:35	6:58
Form 1040EZ					
1998	0:05	0:59	1:23	0:20	2:47
1997	0:05	0:58	1:22	0:20	2:45
1996	0:05	0:57	1:24	0:20	2:46
1995	0:05	0:55	1:22	0:20	2:42
1994	0:05	0:49	1:20	0:40	2:54
1993	0:05	0:44	0:53	0:40	2:22
1992	0:05	0:33	0:39	0:34	1:51
1991	0:05	0:34	0:42	0:40	2:01
1990	0:05	0:34	0:40	0:40	1:59
1989	0:05	0:18	0:30	0:27	1:20
1988	0:07	0:24	0:40	0:20	1:31

"that his computation is not the only possible correct answer" since the tax law is so murky. The tax computed by these pros "ranged from $34,240 to $68,912." The closest answer still erred in the government's favor by $610.

While the recently passed IRS Reform and Restructuring Act requires Congress to at least consider complexity before passing tax legislation, I doubt that will be sufficient incentive for Congress to avoid additional complexity or encourage simplification. The committees should be required to quantify the costs of proposals that add complexity or the savings from proposals that simplify the law.

The National Commission on Restructuring the IRS suggested that Congress consider a quadrennial simplification process, and I hope that Congress and the President will quickly implement such a process either through legislation or by executive order. The Commission found that many members of the private sector tax community were willing to volunteer substantial time to make suggestions for simplification.

A quadrennial simplification commission would harness this volunteer activity and give a broad group of people much more incentive to work for the adoption of simplification rules. This quadrennial commission would also give the Joint Committee on Taxation and the Treasury Department more incentive to suggest simplification of the law.

A New Approach to Taxes Is Needed.

Fundamental overhaul of our tax system remains a critically-important goal. As the Internal Revenue Code becomes increasingly incomprehensible, the intrusive measures provided to the IRS for enforcing it seem to become more draconian. Every detail of a taxpayer's private financial life is open for government inspection. IRS employees can make extraordinary demands on taxpayers, and can take extraordinary actions against them. Mixing such broad powers with a vague and complex law is a recipe for a civil liberty catastrophe. The threat of abuse is always present.

Until we change how we tax income, we will continue to have an intrusive agency with broad powers. It doesn't have to be that way. Our economy as well as our civil liberties would be better off with fundamental tax reform.