FIRST IN SERIES ON TAX CODE SIMPLIFICATION

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

AND

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

JULY 17, 2001

Serial No. 107–40

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE

75–055 WASHINGTON : 2001

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON WAYS AND MEANS

BILL THOMAS, California, *Chairman*

PHILIP M. CRANE, Illinois
E. CLAY SHAW, Jr., Florida
NANCY L. JOHNSON, Connecticut
AMO HOUGHTON, New York
WALLY HERGER, California
JIM McCRERY, Louisiana
DAVE CAMP, Michigan
JIM RAMSTAD, Minnesota
JIM NUSSLE, Iowa
SAM JOHNSON, Texas
JENNIFER DUNN, Washington
MAC COLLINS, Georgia
ROB PORTMAN, Ohio
PHIL ENGLISH, Pennsylvania
WES WATKINS, Oklahoma
J. D. HAYWORTH, Arizona
JERRY WELLER, Illinois
KENNY C. HULSHOF, Missouri
SCOTT McINNIS, Colorado
RON LEWIS, Kentucky
MARK FOLEY, Florida
KEVIN BRADY, Texas
PAUL RYAN, Wisconsin
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ROBERT T. MATSUI, California
WILLIAM J. COYNE, Pennsylvania
SANDER M. LEVIN, Michigan
BENJAMIN L. CARDIN, Maryland
JIM McDERMOTT, Washington
GERALD D. KLECZKA, Wisconsin
JOHN LEWIS, Georgia
RICHARD E. NEAL, Massachusetts
MICHAEL R. McNULTY, New York
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee
XAVIER BECERRA, California
KAREN L. THURMAN, Florida
LLOYD DOGGETT, Texas
EARL POMEROY, North Dakota

Allison Giles, *Chief of Staff*
Janice Mays, *Minority Chief Counsel*

Subcommittee on Oversight

AMO HOUGHTON, New York, *Chairman*

ROB PORTMAN, Ohio
JERRY WELLER, Illinois
KENNY C. HULSHOF, Missouri
SCOTT McINNIS, Colorado
MARK FOLEY, Florida
SAM JOHNSON, Texas
JENNIFER DUNN, Washington
WILLIAM J. COYNE, Pennsylvania
MICHAEL R. McNULTY, New York
JOHN LEWIS, Georgia
KAREN L. THURMAN, Florida
EARL POMEROY, North Dakota

Subcommittee on Select Revenue Measures

JIM McCRERY, Louisiana, *Chairman*

J.D. HAYWORTH, Arizona
JERRY WELLER, Illinois
RON LEWIS, Kentucky
MARK FOLEY, Florida
KEVIN BRADY, Texas
PAUL RYAN, Wisconsin
MICHAEL R. McNULTY, New York
RICHARD E. NEAL, Massachusetts
WILLIAM J. JEFFERSON, Louisiana
JOHN S. TANNER, Tennessee

CONTENTS

FIRST IN SERIES ON TAX CODE SIMPLIFICATION

TUESDAY, JULY 17, 2001

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
Washington, DC.

The Subcommittees met, pursuant to notice, at 2:00 p.m., in room 1100 Longworth House Office Building, Hon. Amo Houghton (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY
FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT
SUBCOMMITTEE ON SELECT REVENUE MEASURES

FOR IMMEDIATE RELEASE
July 10, 2001
No. OV–5

CONTACT: (202) 225–7601

Houghton and McCrery Announce First in a Series of Hearings on Tax Code Simplification

Congressman Amo Houghton (R–NY), Chairman of the Subcommittee on Oversight, and Congressman Jim McCrery (R–LA), Chairman of the Subcommittee of Select Revenue Measures, Committee on Ways and Means, today announced that the Subcommittees will hold the first in a series of hearings on the need for simplification of the Internal Revenue Code (IRC). **The hearing will take place on Tuesday, July 17, 2001, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 2:00 p.m.**

Oral testimony at this hearing will be from invited witnesses only. However, any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing. Future hearings will review specific reform proposals.

BACKGROUND:

Under Section 4022(a) of the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (P.L. 105–206), the Joint Committee on Taxation (JCT) is required at least once every Congress to provide a comprehensive study on the state of the Federal Tax system. In April of this year, the JCT released a document entitled “Study of the Overall State of the Federal Tax System and Recommendations for Simplification” (JCS–3-01), outlining the complex nature of the IRC, and providing recommendations for its simplification.

Compiled and instituted into American society shortly before World War I, the IRC has gone through enormous revisions and additions, enough to make it the most complex income tax code in history. A number of economists and academics have documented the ways in which complexity increases the costs of our current tax system.

“The Oversight Subcommittee continues to hear from individuals, businesses, and tax professionals about complexity in our income tax system,” said Chairman Houghton. “Our first hearing will explore the costs of tax complexity and review the very comprehensive report of the Joint Committee on Taxation.”

“For most Americans, the term ‘tax simplification’ is an oxymoron like ‘deafening silence’ or ‘jumbo shrimp’,” remarked Chairman McCrery. “I am hopeful this hearing and our joint efforts will help rid the tax code of some of its complexity, reducing the frustration so closely associated with paying taxes.”

FOCUS OF THE HEARING:

The hearing will focus on the nature and cost of complexity in the tax code and the options for tax simplification.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should *submit six (6) single-spaced copies of their statement, along with an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, with their name, address, and hearing date noted on a label*, by the close of business, Tuesday, July 31, 2001, to Allison Giles, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, by close of business the day before the hearing.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be submitted on an IBM compatible 3.5-inch diskette in WordPerfect or MS Word format, typed in single space and may not exceed a total of 10 pages including attachments. **Witnesses are advised that the Committee will rely on electronic submissions for printing the official hearing record.**

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, company, address, telephone and fax numbers where the witness or the designated representative may be reached. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press, and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are available on the World Wide Web at “http://waysandmeans.house.gov”.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202–225–1721 or 202–226–3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

Chairman HOUGHTON. If I can have your attention, I think we will call the meeting to order. I am going to say a few things, and then I will turn over the mike to Mr. McCrery, who is the co-leader here, and then I will recognize Mr. Coyne and Mr. McNulty.

What I would like to do is begin by noting that this is, as I mentioned earlier, a joint hearing of the Oversight and Select Revenue Measures Subcommittees, and I have the gavel because I outweigh and I out-age my colleague, Mr. McCrery, and I haven’t been treated, frankly, with the proper respect over the years.

The Oversight Subcommittee has a long history of activity on tax simplification, and I certainly welcome the participation of the Select Revenue Measures Members in the important need to simplify our Tax Code. What I have here in my hand is the number of pages used for our income taxes in 1913. Now, I was not alive in 1913, but that is what it was.

Now, I was alive in 1937, and the four pages have now grown to eight. However, if you will look down here right in front of me, this is the requirement for the income tax reporting in 2000. The current Tax Code is so complex that I couldn't begin to hold up those forms and the pages of instructions put out by the IRS, but they are right here in front of me.

Our past hearings have given us a range of numbers on the cost and complexity of the Tax Code. The lowest estimates, in the range of $75 billion per year, commonly include only the cost of preparing Federal income tax forms. If you add up all the costs of the Federal tax system including education, recordkeeping, preparing returns, governmental administration, tax litigation and things like that, the total overall overhead cost of our Federal tax system is probably in the range of $200 billion, and I really think that is a conservative estimate. So think what we could do if we had that available—that amount of money available for health care or other important activities.

So today's hearing really is going to begin our quest to simplify the Tax Code. I don't know that we can do it, but we are going to have a mighty effort in that regard. We will hear from several witnesses who have studied the complexity of the system and its cost to society, and we will also review the excellent report produced by the Joint Committee on Taxation (JCT) for which we commend Mrs. Paull very much, and her staff.

So future hearings—so this is not the only one. Future hearings will examine a host of other simplification recommendations. And I understand that the Treasury Department is reviewing the simplification study done by the Joint Committee on Taxation together with simplification proposals advanced by the IRS Restructuring Commission, National Taxpayer Advocate, a number of professional associations. And also, in addition, the Treasury Department will be developing proposals that were not addressed by these other reports.

Now, a future hearing is going to require the Treasury Department to come back at us and give the opportunity to present specific proposals that would simplify the tax system and provide for enhanced economic growth. We look forward to hearing the Treasury Department's recommendations when the analysis is complete.

And I am now pleased to yield to the Chairman of the Subcommittee for Select Revenue Measures, Mr. McCrery.

[The opening statement of Chairman Houghton follows:]

Opening Statement of the Hon. Amo Houghton, a Representative in Congress from the State of New York, and Chairman, Subcommittee on Oversight

Good Afternoon. Let me begin by noting that this is a joint hearing of the Oversight and Select Revenue Measures Subcommittee. I think I have the gavel either because I outweigh or out-age my colleague Chairman McCrery. The Oversight Subcommittee has a long history of activity on tax simplification and I welcome the participation of the Select Revenue Measures Members in the important need to simplify our tax code.

What I have here in my hand is the total number of pages used for our income taxes in 1913—four simple pages. By 1937 the tax return had grown to four pages with another four pages of instructions. But the current tax code is so complex I couldn't begin to hold up all the forms and pages of instructions put out by the IRS—thousands of pages—and they are displayed here in front of me.

Our past hearings have given us a range of numbers on the cost of complexity in the tax code. The lowest estimates, in the range of $75 billion per year, commonly include only the cost of preparing federal tax forms. If you add up all the costs of the federal income tax system, including the cost of:

- education;
- record-keeping;
- preparing returns;
- paid preparers;
- governmental administration;
- tax litigation;
- and the substantial costs associated with tax planning the total overhead cost of our federal tax system is probably in the range of $200 billion per year. Think of what we could do it we had that available for heath care or other important activities.

Today's hearing will begin our quest to simplify the tax code. We will hear from several witnesses who have studied the complexity in our tax system and its cost to society. We will also review the excellent report produced by the Joint Committee on Taxation, for which we commend Ms. Paull and her staff.

Future hearings will examine a host of other simplification recommendations. I understand that the Treasury Department is reviewing the simplification study done by the Joint Committee on Taxation together with simplification proposals advanced by the IRS Restructuring Commission, the National Taxpayer Advocate, and a number of professional associations. In addition, the Treasury Department will be developing proposals that were not addressed by the other reports.

A future hearing will provide the Treasury Department the opportunity to present specific proposals that would simplify the tax system and provide for enhanced economic growth. We look forward to hearing the Treasury Department's recommendations when the analysis is complete and will welcome the views of other groups on this important topic.

I am pleased to yield to the Chairman of the Subcommittee on Select Revenue Measures, Mr. McCrery.

Chairman MCCRERY. Thank you. It is a pleasure to co-host this hearing with the Oversight Subcommittee. The Select Revenue Measures Subcommittee is certainly interested in the findings of the Oversight Committee with respect to tax simplification and potentially moving forward legislation at some point to make the Tax Code more simple.

Chairman Houghton has said pretty much what I would say in my opening remarks, and, in the interest of time, I would submit for the formal record my written opening remarks and yield back to the Chairman.

[The opening statement of Chairman McCrery follows:]

Opening Statement of the Hon. Jim McCrery, a Representative in Congress from the State of Louisiana, and Chairman, Subcommittee on Select Revenue Measures

Good afternoon. Today, I am pleased the Select Revenue Measures Subcommittee is joining Chairman Houghton and our colleagues on the Oversight Subcommittee in the first in a series of hearings on the ever-timely topic of tax code complexity.

For most Americans, the term 'tax simplification' is an oxymoron like 'deafening silence,' or 'jumbo shrimp'. As society has become more complex, so has the tax code. In raw terms, the number of words in the tax code grew from 235,000 in 1964 to almost 800,000 words in 1994—an increase of more than 300 percent!

Our constituents are rightly frustrated by the billions of hours they spend trying to figure out how much tax they owe Uncle Sam.

It may be impossible to quantify the frustration folks experience as they scour tax forms and the accompanying pages of instructions.

But it is possible to measure the difficulty of the code itself. Consider the fact that a Treasury Department sampling of service at IRS walk-in clinics found taxpayers were given accurate answers less than one-third of the time.

The implications are clear: even the IRS' own employees who are trained and paid to understand the tax code and work through individual problems have difficulty doing so.

That strongly argues to me the importance of finding ways to simplify the code.

Today's hearing will begin this inquiry for the 107th Congress. We will hear from several groups about the societal costs of complexity, which include the billions of hours and dollars spent by individuals and corporations trying to comply with our tax system.

I also look forward to hearing from Lindy Paull, whose staff at the Joint Tax Committee produced a thorough examination of the causes and cures for tax code complexity. Their recommendations will be extremely helpful as we further pursue this matter.

As I stated at the outset, this is the first in a series of hearings on this important issue and I look forward to working with my colleagues as we look for solutions.

Chairman HOUGHTON. Thanks very much, Mr. McCrery, and also I am honored to be able to do this thing with you. What I would like to do is call my friend here, Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. It is helpful that this hearing be held to discuss the need for tax simplification. I believe that the time for tax simplification is now. We must make the decision to simplify the Tax Code and make tax reform a high priority. The Oversight Subcommittee has held numerous tax simplification hearings. In 1998 we held hearings on the impact of the tax law complexity on individual taxpayers and businesses. At the beginning of each year since then, we have held a tax return filing season hearing which included discussion of tax complexity and the most common taxpayer and tax practitioner errors.

As the Subcommittees proceed this year, I suggest that we consider simplification measures that address both simpler Tax Code rules and improved IRS notices, forms, and instructions. The Joint Committee on Taxation's April 2001 simplification report is an excellent document. This report was mandated by the 1998 IRS Reform Act to provide the Congress with a professional and objective analysis of why the tax laws are complex and how the tax laws can be simplified. The study outlines in quite specific terms what could be done to simplify the Code.

I want to thank Chairman Houghton for keeping tax simplification at the top of the Oversight Subcommittee's agenda. I look forward to developing a tax simplification package and also to working with all members of both Subcommittees on tax simplification throughout the year. Thank you, Mr. Chairman.

[The opening statement of Mr. Coyne follows:]

Opening Statement of the Hon. William J. Coyne, a Representative in Congress from the State of Pennsylvania

I am pleased that today's joint Subcommittee hearing has been scheduled to discuss the need for tax simplification. Having introduced and sponsored tax simplification legislation in the past, with Congressman Neal and others, I can tell you there are simple solutions to some of the most complex tax Code provisions.

As Ranking Member of the Oversight Subcommittee and a Member of the IRS Restructuring and Reform Commission, I believe that the time for tax simplification is now. We must make the decision to simplify the tax Code and make reforms a priority.

Since I have been Ranking Member, the Oversight Subcommittee have held numerous tax simplification hearings. In 1998, we held hearings on the impact of tax law complexity on individual taxpayers and businesses. At the beginning of each year, we held a tax return filing season hearing which included discussion of tax complexity and the most common taxpayer and tax-practitioner errors.

As the Subcommittees proceed this year, I suggest that we consider simplification measures that address both simpler tax Code rules and improved IRS notices, forms and instructions.

Finally, the Joint Committee on Taxation's April 2001 simplification report is excellent. This report was mandated by the 1998 IRS Reform Act to provide the Congress with a professional and objective analysis of why the tax laws are complex and how the tax laws can be simplified. The study outlines in quite specific terms what needs to be done.

In conclusion, I want to thank Chairman Houghton for keeping tax simplification in the top of the Oversight Subcommittee's agenda. I look forward to developing a tax simplification package for quick action this why the tax laws are complex and how the tax laws can be simplified. The study outlines in quite specific terms what needs to be done. I want to thank Lindy Paull, Chief of Staff of the Joint Committee on Taxation, for a job well done.

In conclusion, I want to thank Chairman Houghton for keeping tax simplification in the top of the Oversight Subcommittee's agenda. I look forward to working with all members of both Subcommittees in tax simplification throughout the year.

Chairman HOUGHTON. Thanks very much, Mr. Coyne. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I ask unanimous consent that all members of the two Subcommittees have 5 legislative days in which to submit statements for the record.

Mr. Chairman, today our two Subcommittees are joined together to discuss one of the most frustrating issues facing taxpayers: the complexity of our tax laws. The witnesses' testimony will provide us with an excellent basis for analyzing the specific tax law provisions that deserve our priority attention for simplification. Tax simplification has strong and widespread bipartisan support. Given this, I would hope that the Committee will decide to take tax simplification seriously and do more than just holding hearings.

We have been talking about tax simplification for years, but little has been done. Instead, the tax laws have, as you have pointed out, Mr. Chairman, become more and more complicated and taxpayers, justifiably, are becoming more frustrated. I believe that we could develop a tax simplification legislative package immediately. As a priority, we should focus on those tax provisions that impose significant unnecessary burdens on the greatest number of individual taxpayers. Simplification could begin with reforms to the earned income tax credit, alternative minimum tax, education credits, capital gains, and other areas affecting average working individuals and their families.

There is no question that the tax laws are complicated and that simplification reforms are needed. The real question is when will the Committee act to simplify the Tax Code. And, much more important than simplification, it is critical that any reforms we enact are fair to average taxpayers. Mr. Chairman, I look forward to working with you and the Members of the Committee on this subject. Thank you.

[The opening statement of Mr. McNulty follows:]

Opening Statement of the Hon. Michael R. McNulty, a Representative in Congress from the State of New York

Today the select revenue measures and oversight subcommittees are joining together to discuss one of the most frustrating issues facing taxpayers—the complexity of our tax laws. The witnesses' testimony will provide us with an excellent basis for analyzing the specific tax law provisions that deserve our priority attention for simplification.

Tax simplification has strong and widespread bipartisan support. given this, I would hope that the committee will decide to take tax simplification seriously and do more than just holding hearings. We've been talking about tax simplification for years but little has been done. Instead, the tax laws have become more and more complicated and taxpayers justifiably are becoming more frustrated.

I believe that we could develop a tax simplification legislative package immediately. As a priority, we should focus on those tax provisions that impose significant, unnecessary burdens on the greatest number of individual taxpayers. Simplification could begin with reforms to the earned income tax credit, alternative minimum tax, education credits, capital gains, and other areas affecting average, working individuals and their families.

There is no question that the tax laws are complicated and that simplification reforms are needed. the real question is when will the committee act to simplify the tax code?

And much more important than simplification—it is critical that any reforms we enact are fair to average taxpayers.

I look forward to working with the members of the two subcommittee's on this important issue.

Thank You.

Chairman HOUGHTON. Thanks very much, Mr. McNulty.

Unless other people have opening statements, Mrs. Paull, we are delighted to have you here, and please proceed.

STATEMENT OF LINDY PAULL, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION

Mrs. PAULL. Thank you, Mr. Chairman, and Mr. Chairman, and Members of the Subcommittees. Let me start by thanking you for holding this series of hearings. I am especially appreciative of you inviting us to present to you the report that we did earlier this year on the overall state of the Federal tax system and our recommendations on ways to make it a little bit more simple.

Simplification of the Tax Code is really an ongoing process. It requires a lot of diligence, and it requires a lot of focus on the ways that we write our tax laws. And I think this project was really quite an interesting one for our staff to engage in, to step back and take a big broad look at the Tax Code. So we thank you for inviting us to do that as well.

Our report, of course, stems from the work of this Committee leading to the 1998 IRS Restructuring Act. And I also would like to thank everybody who contributed to the work of this study, because it was not only our staff which did a tremendous job on the report but also our colleagues at the U.S. General Accounting Office (GAO), the Congressional Research Service (CRS), and we elicited some outside advisors to help us as well, and it was quite a pleasure to work with all of them.

I have submitted written testimony for the record, and I would just like to provide some highlights of that testimony so that there will be ample time for questions. I also thank you for accommodating my schedule. The Committee has a major markup tomorrow and we are getting ready for that as well; so, thank you for that.

There is no doubt that the tax system is complex, illustrated by Chairman Houghton's very high stack of instructions and forms and publications that the IRS puts out on an annual basis to assist taxpayers in complying with the tax law.

We have over 100 million individual income tax returns that are filed annually on behalf of about 90 percent of the U.S. population, and the individual income tax return itself consists of about 79 lines, 144 pages of instructions, 11 schedules that have another 443 lines, 19 separate work sheets, the possibility of having to file numerous other forms and to have to look and to consult with all kinds of other schedules and instructions. So it is quite a complicated, daunting and intimidating task for taxpayers when they sit down to try to do their annual tax return.

The Tax Code consists of approximately 1.4 million words. Almost 700 sections of the Tax Code are applicable to individual taxpayers, over 1,500 sections are applicable to businesses, and almost 500 sections to tax-exempt organizations, employee plans, and so forth. There are almost 20,000 pages of regulations, encompassing about 8 million words that you have to try to sort through on various topics of the tax area, and there are a lot of missing regulations as well.

Another interesting thing that we would note is that the number of paid tax return preparers has increased over the last decade, from about 48 percent of individual returns to 55 percent, which is almost a 27-percent increase. And the use of computer software for the preparation of income tax returns has increased even more, from about 16 percent in 1990 to 46 percent now. Some of the complexity of the Tax Code is actually hidden in the sense that you go to a tax preparer, you use computer software as opposed to having to try to sort through the returns and do it yourself.

As a part of the study, we undertook a review of all the present-law tax provisions. We didn't focus only on one, but obviously we spent a lot more attention on the individual side and the complexity with respect to small businesses, because we thought that was one of the principal emphasis from the IRS Restructuring Act. And we determined that there was really no single cause of complexity. There are a multitude of causes. There are many, many factors, and you have to be diligent in all aspects of the tax law in order to try to make a change so that the complexity doesn't overcome and overwhelm the system. It is quite close to doing that right now.

In the course our study we were able to identify numerous areas of the tax law that could be simplified. We did not think that our mission was to compare the current Tax Code to a theoretical or a perfect world Tax Code, but to look at the Tax Code and explore, considering the policies that have been enacted, are there simpler ways to go about implementing the policy that the Congress was desirous of achieving through those provisions of the tax law?

So what we were identifying were areas where we thought you could go about achieving the same goal, but do it in a simpler way. In many instances, we found that there are multiple tax provisions that are trying to achieve the same thing. We explored whether they could be combined into one so that you would have one way of achieving that goal.

In some instances we ultimately decided, especially with respect to the structure of the Tax Code, that there were so many policy issues involved in some of these structural issues that we could not make a recommendation. For example, the multiple filing statuses or whether or not you have one pass-through entity regime versus a different tax system for subchapter S corporations, partnerships, and other entities. While we didn't make a recommendation on it, we certainly left you a road map for us to come back and do some further work if after you have reviewed our report you wanted us to look further into it.

In addressing the simplification, we have a few recommendations on how to tackle what seems to be an overwhelming effort to simplify the Tax Code. First, we would echo I think what has already been said, that particular attention ought to be paid to recommendations that have widespread applicability to individuals. For example, a simplification recommendation that we made with respect to the alternative minimum tax, and with respect to uniform definition of a child for various purposes of the Tax Code, ought to be given a very high priority by the Congress because so many people are affected by those provisions.

There is another tier of recommendations that we made that basically involve the notion of uniform definitions that—although we haven't estimated all our recommendations—we think that are probably pretty low cost and would give a coherence in the Tax Code and get rid of so-called dead wood, out-of-date provisions. We identified over a hundred of those provisions in the Tax Code. It would be a relatively simple proposition to go about doing that.

The third thing we would urge—which we would participate in this when you are marking up a tax bill—is that when you are marking up a tax bill and you are adding new provisions to the Tax Code, some weight ought to be given to the benefit of the policy that you are trying to promote through the Tax Code versus the complexity and additional stacks of paper you are going to be adding to the instructions on the forms.

And, finally, we would ask that you follow up on some of the structural issues that we identified. We identified over 20 area that would be major projects and would involve a significant amount of policy decisions. So it would be up to the Congress to move forward those types of policy changes.

Since my time is up and the report has been out since April, I will not highlight our specific recommendations as I had intended to. I would be happy to answer any questions you may have. Again, I appreciate you inviting me to appear before you today, and I think it is great that you are holding these hearings on tax code simplification.

[The prepared statement of Mrs. Paull follows:]

Statement of Lindy Paull, Chief of Staff, Joint Committee on Taxation

My name is Lindy Paull. As Chief of Staff of the Joint Committee on Taxation, it is my pleasure to present the written testimony of the staff of the Joint Committee on Taxation (the "Joint Committee staff") at this hearing concerning the complexity of the Internal Revenue Code (the "Code").[1]

The Joint Committee staff completed in April of 2001 a statutorily mandated study of the overall state of the Federal tax system.[2] This study included a thorough review of the Federal tax system and made more than 100 recommendations for proposals to simplify the Federal tax system. Our testimony today will review some of the findings of our study, suggest an approach to addressing legislatively some of the complexity of the Federal tax system, and discuss specific recommendations that we believe would achieve the greatest simplification to the Federal tax system.

A. Background Information on Tax Law Complexity and the Joint Committee Staff Study

There is no doubt that the Federal tax system is complex and that this complexity affects almost all Americans. In the course of our study, we found extensive evidence of the complexity of the Federal tax system, including the following:

- Over 100 million individual income tax returns are filed annually on behalf of roughly 90 percent of the U.S. population.
- A taxpayer filing an individual tax return could be faced with a return consisting of 79 lines (Form 1040), 144 pages of instructions, 11 schedules totaling 443 lines, 19 separate worksheets, and the possibility of having to file numerous other forms. For 1999, IRS publications included 649 forms, schedules, and instructions, 159 worksheets imbedded in instructions, and approximately 340 publications.
- The Code consists of approximately 1,395,000 words. There are 693 sections of the Code that are applicable to individual taxpayers, 1,501 sections applicable to businesses, and 445 sections applicable to tax-exempt organizations, employee plans, and governments.
- As of June 2000, the Treasury Department had issued almost 20,000 pages of regulations containing over 8 million words.
- The use of paid return preparers increased from 48 percent of returns filed in 1990 to 55 percent of returns filed in 1999 (a 27 percent increase) and the use of computer software for return preparation increased from 16 percent of returns filed in 1990 to 46 percent of returns filed in 1999 (a 188 percent increase).

The complexities of the Federal tax system and the associated problems such complexities create have received considerable and increasing attention from the Congress, the Administration, taxpayer groups, and tax professionals.[3] While complexity of the Federal tax system has been a concern almost since the inception of the income tax, concerns regarding complexity have intensified over the past decade. As part of growing concern over complexity, the Congress mandated that the Joint Committee staff study the Federal tax system and make recommendations for simplification.

As part of this study, we undertook a review of all provisions of present law. We determined that there is no single cause of complexity. The complexity of the Federal tax system has developed over many years and is the result of many different factors, including frequent changes in the law, the use of temporary provisions, administrative guidance, judicial interpretations, and the effects of the Congressional budget process. In addition, simplicity often is in conflict with other policy objectives, such as fairness and efficiency.

The cost of complexity for taxpayers cannot be easily quantified. Complexity results in increased time required by taxpayers to prepare and complete tax returns,

---

[1] This testimony may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation at a Hearing of the Subcommittees on Oversight and Select Revenue Measures of the House Committee on Ways and Means Concerning Complexity of the Internal Revenue Code* (JCX–60–01), July 17, 2001.

[2] Code sec. 8022(3)(B). This provision was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. No. 105–206). Preparation of the Joint Committee study is subject to specific appropriations by the Congress. For fiscal year 2000, the staff of the Joint Committee staff advised the House and Senate Committees on Appropriations that an appropriation of $200,000 would be required for the Joint Committee staff to undertake the study and amounts were appropriated for this purpose. The three-volume report of the study was published in April 2001. Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986* (JCS–3–01), April 2001. A copy of the executive summary for the Joint Committee study is attached to this testimony.

[3] *See, e.g.*, Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 79 N.C. L. Rev. 151 (Nov. 1997); *Most Serious Problem? Complexity!*, J. Acct. (Feb. 1999) (discussing the AICPA tax executive committee's list of the most serious problems encountered by taxpayers); Amy Hamilton, *Tax Law Complexity Ranks 1st—* and—2nd Among Taxpayer Problems, 90 Tax Notes 140 (Jan. 8, 2001).

increased use of tax return preparers, and increased taxpayer requests for assistance by the IRS. The burdens of complexity fall particularly on individual taxpayers. For example, to receive many tax benefits, individuals must assess their eligibility, retain records, and prepare the proper forms or worksheets. Even though there is no reliable estimate of the cost of the complexity of the Federal tax system, it is clear that complexity results in an increase in the time and money required to comply with the Federal tax system. Complexity also undermines faith in the tax system and can undermine voluntary compliance with the tax laws.

In the course of our study, we identified specific sources of complexity in the Federal tax system and made more than 100 simplification recommendations involving virtually every area of the Federal tax system. We identified complexity associated with structural aspects of the Federal tax system, but we did not make specific recommendations in these areas because we did not believe that it was within the scope of our study to make recommendations that would alter the underlying policy decisions made by the Congress. However, we believe that these areas also should be considered as part of any simplification process.

Given the breadth and depth of the complexity of present law, there is no quick fix to achieve simplification. We believe that simplification of the Federal tax system is a long-term and ongoing process that requires a systematic approach by the Congress.

B. Addressing Simplification Issues

Because of the magnitude of the task of simplifying the Federal tax system, we believe that the Congress should prioritize its simplification objectives. Therefore, we make the following suggestions with respect to a process by which the Congress could address the issue of simplifying the Federal tax system:

(1) The Congress should first consider simplification recommendations that affect the largest numbers of individual taxpayers. Particular attention should be given to simplification recommendations affecting low-income taxpayers who lack the resources to cope with complex Federal tax laws. Complexity for individual taxpayers contributes not only to increased costs of compliance with Federal tax laws, but also to reduced respect for the Federal tax system. We have made a number of simplification recommendations, such as repeal of the alternative minimum tax, that we believe fall into this category. These recommendations are discussed below.

(2) The Congress should consider other simplification recommendations that have either a relatively small revenue effect or achieve modest amounts of simplification without great disruption for taxpayers. For example, we recommend the elimination of over 100 obsolete or near obsolete provisions in the Internal Revenue Code. While any one of these recommendations will not affect large numbers of taxpayers, collectively these recommendations would improve the clarity of the Federal tax system. Other recommendations from our study that fit into this category, such as the adoption of uniform definitions of terms in the Code, are discussed below.

(3) When changes are made or new provisions are added to the Code, the Congress should give more consideration to the overall effect on complexity of the Federal tax system. Simplification of the Federal tax system is an ongoing process, which is undermined by the enactment of new complex tax provisions.

(4) The Congress should consider whether there are structural issues in the Federal tax system that should be addressed. In our study, we identified areas of complexity in the Federal tax system for which specific recommendations were not made. We believe these issues were beyond the scope of our study because they involve significant underlying policy decisions made by the Congress. However, we believe that simplification cannot be fully achieved without revisiting some of these structural issues.

We highlight below our simplification recommendations that we believe should be considered first by the Congress. A complete discussion of our specific recommendations concerning each particular issue can be found in our published report on the simplification study.

C. Specific Joint Committee Staff Recommendations

1. Individual income tax

In general

In our study, we focused significant time and effort on identifying areas of complexity for individual taxpayers. We believe that simplification recommendations affecting the largest number of individual taxpayers should be given the highest priority. Additionally, several complex individual provisions affect low-income taxpayers who generally are not assisted by sophisticated tax advisors and we believe these recommendations should also be given priority consideration.

Although we believe that all of our individual income tax simplification recommendations should be considered by the Congress, we believe certain provisions warrant special attention.

Alternative minimum tax

As a top priority, we recommend that the individual and corporate alternative minimum tax should be eliminated. The alternative minimum tax contributes complexity to the present-law Federal tax system by requiring taxpayers to calculate Federal income tax liability under two different systems. The alternative minimum tax causes complexity not only for taxpayers with minimum tax liability; although a taxpayer ultimately may not have a minimum tax liability, many taxpayers must make the computation to determine if they do.

We believe that the individual alternative minimum tax no longer serves the purposes for which it was intended. The present-law structure of the individual alternative minimum tax expands the scope of the provision to taxpayers who were not intended to be alternative minimum tax taxpayers. It is expected that many taxpayers are, and will in the future become, individual alternative minimum taxpayers because they (1) have large families, (2) live in States with high income taxes, or (3) have significant capital gains. Other special situations, such as large medical expenses, could also result in minimum tax liability.

We believe that the corporate alternative minimum tax no longer serves the purpose for which it was intended. The corporate alternative minimum tax adjustments do not necessarily produce a more accurate measurement of economic income than the regular tax, which was the original purpose of the corporate alternative minimum tax.

For 2001, it is estimated that 1.4 million individual tax returns are affected by the alternative minimum tax. By 2010, this number is projected to grow to 35.5 million individual tax returns. The number of individual taxpayers required to comply with the complexity of the individual alternative minimum tax calculations will continue to grow due to the lack of indexing of the minimum tax exemption amounts and the effect of the individual alternative minimum tax on taxpayers claiming nonrefundable personal credits. The Economic Growth and Relief Reconciliation Act of 2001 provided some relief from the individual alternative minimum tax; for example, the Act increased the exemption amount for individuals for 2001 through 2004. The Act also provided other alternative minimum tax relief and provided that, after 2001, there is no reduction in the child credit or earned income credit because of the alternative minimum tax.[4]

However, other provisions of the Economic Growth and Tax Relief Reconciliation Act will cause additional complexity as a result of the alternative minimum tax rules. It is estimated that for the year 2010, 18 million additional individual income tax returns that will benefit from the Act's rate reductions, increased standard deduction, and expanded 15-percent rate bracket will be affected by the alternative minimum tax. For these taxpayers, it could be expected that the interaction of the provisions with the alternative minimum tax rules would result in an increase in tax preparation costs and in the number of individuals using a tax preparation service.

Uniform definition of a qualifying child

We recommend that a uniform definition of qualifying child should be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care tax credit, and head of household filing status. In order to determine whether a child qualifies a taxpayer for each of the provisions, the taxpayer must apply up to five different tests.

The different rules regarding qualifying children have been identified as a source of complexity for taxpayers for over a decade. The rules relating to qualifying children are a source of errors for taxpayers both because the rules for each provision are different and because of the complexity of particular rules. The variety of rules causes taxpayers inadvertently to claim tax benefits for which they do not qualify as well as to fail to claim tax benefits for which they do qualify. Adopting a uniform definition of qualifying child would make it easier for taxpayers to determine whether they qualify for the various tax benefits for children and reduce inadvertent taxpayer errors arising from confusion due to different definitions of qualifying child.

[4] This provision is subject to the general sunset of the Act.

Often, the individual taxpayers who are affected by the varying definitions of a qualifying child are low-income taxpayers who do not have access to competent tax advisors. Therefore, we believe that simplification in this area will directly benefit millions of low- and moderate-income taxpayers.

Our recommendation would provide simplification for substantial numbers of taxpayers. Under present law, it is estimated that, for 2001, 44 million returns will claim a dependency exemption for a child, 19 million returns will claim the earned income credit, 6 million returns will claim the dependent care credit, 26 million returns will claim the child credit, and 18 million returns will claim head of household filing status.

The Economic Growth and Tax Relief Reconciliation Act of 2001 adopted our recommendation on the definition of qualifying child for purposes of the earned income credit, but did not go the further step of applying the definition to the dependency exemption, the child credit, the dependent care credit, and head of household filing status. Thus, a uniform definition is still urgently needed for all of these provisions.

Phase-outs and phase-ins

We recommend that various phase-outs and phase-ins applicable to individuals should be eliminated. We recommend that the following phase-outs should be eliminated: (1) overall limitation on itemized deductions (known as the "PEASE" limitation); (2) phase-out of personal exemptions (known as "PEP"); (3) phase-out of child credit; (4) partial phase-out of the dependent care credit; (5) phase-outs relating to individual retirement arrangements; (6) phase-out of the HOPE and Lifetime Learning credits; (7) phase-out of the deduction for student loan interest; (8) phase-out of the exclusion for interest on education savings bonds; and (9) phase-out of the adoption credit and exclusion.

These phase-outs require taxpayers to make complicated calculations and make it difficult for taxpayers to plan whether they will be able to utilize the tax benefits subject to the phase-outs. Taxpayers in the phase-out range must perform separate worksheet calculations to determine the amount of allowable tax benefit. In addition to the additional time required of a taxpayer to educate himself or herself on the applicability of the phase-out to their particular circumstances, the worksheets themselves can be quite complicated to complete. This increases both the time required to prepare a return and the probability of making an error.

Eliminating the phase-outs would eliminate complicated calculations and make planning easier. These phase-outs primarily address progressivity, which could be more simply addressed through the rate structure. Elimination of the phase-outs would provide simplification for up to 30 million returns that are subject to one or more of the present-law phase-outs and phase-ins.

The Economic Growth and Tax Relief Reconciliation Act of 2001 provided some simplification of phase-out complexity. The phase-out of the personal exemption and the overall limitation on itemized deductions will be gradually repealed after 2006 and completely eliminated after 2009. However, the provisions repealing the phase-outs are subject to the general sunset of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Provisions relating to education

Our study includes several recommendations with respect to education provisions. These recommendations include the following: (1) a uniform definition of qualifying higher education expenses should be adopted; (2) the HOPE and Lifetime Learning credits should be combined into a single credit; and (3) the restrictions on interaction among various education tax incentives should be revised.

Numerous present-law provisions allow taxpayers to reduce the cost of post-secondary education and also provide special rules governing the tax treatment of qualified scholarships and fellowships, the forgiveness of certain student loans, and withdrawals from IRAs for educational expenses. The numerous provisions relating to education create transactional complexity for taxpayers making it difficult to determine which tax benefit is best for them.

The present-law education incentives are structured in several different ways. Understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interaction between different incentives and provisions within each incentive, as well as the different recordkeeping and reporting requirements that may apply, can be time consuming and confusing for taxpayers and lead to inadvertent errors.

Two of the recommendations included in our study were adopted in the Economic Growth and Tax Relief Reconciliation Act of 2001; the 60-month limit on the student loan interest deduction was eliminated and the exclusion for employer-provided educational assistance was made permanent.[5] Nevertheless, other sections of the Economic Growth and Tax Relief Reconciliation Act of 2001 added to the complexity of the tax law relating to education, increasing the need for simplification in this area.

Other individual tax simplification recommendations

Our study contains other recommendations with respect to individual income tax issues, including the following:

(1) The dependent care credit and the exclusion for employer-provided dependent care assistance should be conformed. This would eliminate the confusion caused by different rules for the two present-law tax benefits for dependent care expenses and could provide simplification for as many as 6 million returns.

(2) Determination of head of household and surviving spouse statuses should be simplified. Filing status errors are common and can cause errors throughout a tax return.

(3) Taxation of Social Security benefits should be simplified by providing a fixed percentage of benefits that are includible in income for all taxpayers. Computation of the taxable portion of social security benefits is extremely complicated and results in frequent errors. Our recommendation could provide simplification for as many as 12 million returns that show taxable Social Security benefits.

(4) The current rate system for capital gains should be replaced with a deduction equal to a fixed percentage of the net capital gain available to all individuals. Our recommendation would simplify the computation of a taxpayer's tax on capital gains and streamline the capital gains tax forms and schedules for individuals for as many as 27 million returns estimated to have capital gains or losses in 2001.

(5) The definition of "small business" for capital gain and loss provisions should be conformed. The different definitions of small business for the special gain and loss rules can create taxpayer confusion and uncertainty as to whether an investment qualifies for the special rule.

(6) The two-percent floor applicable to miscellaneous itemized deductions should be eliminated. The two-percent floor applicable to miscellaneous itemized deductions has added to complexity because it has (1) placed pressure on individuals to claim that they are independent contractors, rather than employees; (2) resulted in extensive litigation with respect to the proper treatment of certain items, such as attorneys' fees; (3) resulted in inconsistent treatment with respect to similar items of expense; and (4) created pressure to enact deductions that are not subject to the floor. Although the two-percent floor was enacted, in part, to reduce complexity, it has instead shifted complexity to these other issues relating to miscellaneous itemized deductions.

(7) The taxation of minor children should be simplified by expanding the election to include a child's income on the parents return and eliminating the interaction of the child's return with other returns by applying trust rates to the child's income. The rules relating to the taxation of minor children are complicated and require the completion of multiple worksheets to calculate a child's income and appropriate amount of tax.

2. Recommendations that would be relatively simple to implement

We believe that the Congress should include as a priority those recommendations that would be relatively simple to achieve or would have a relatively low revenue effect. While such changes may not have a widespread impact on the Federal tax system, implementing the recommendations would improve the readability of the Code and would be a logical step in the simplification process.

We recommend that out of date and obsolete provisions in the Code should be eliminated. We identified (1) more than 100 provisions that could be eliminated as deadwood, and (2) several obsolete and near-obsolete tax-exempt bond provisions.

We have recommended a number of areas in the Federal tax system that can be simplified by the use of uniform definitions. Great complexity results from inconsistent definitions assigned to the same term. Uniform definitions would eliminate the need for taxpayers to understand multiple definitions and make multiple determinations, and would reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions. Uniform definitions would also reduce inconsistencies in the Code.

Uniform definitions of terms is a core foundation of a simplified tax system. Assigning uniform definitions to terms should be a relatively simple process with mini-

[5] The provisions are subject to the general sunset of the Act.

mal revenue cost. Our report includes many recommendations for uniform terms, including the following:

(1) A uniform definition of compensation should be used for all qualified retirement plan purposes;

(2) Uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes;

(3) A uniform definition of employees who may be excluded for purposes of the application of the nondiscrimination requirements relating to group-term life insurance, self-insured medical reimbursement plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits, and voluntary employees' beneficiary associations should be adopted;

(4) A uniform definition of a family should be used in applying the attribution rules used to determine stock ownership;

(5) The references in the Code to "general partners" and "limited partners" should be modernized consistent with the purposes of the references; and

(6) A single definition of highway vehicle should be enacted to eliminate taxpayer uncertainty about the taxability of motor fuels and retail sales.

3. Other recommendations

Our study includes numerous other recommendations for simplification of the Federal tax system. We recommend changes to virtually every area of the Federal tax system. While we suggest that the individual income tax and modest recommendations should have the highest priority, we believe that other simplification recommendations should also be considered.

D. Conclusion

Simplification of the Federal tax system is not an easy task. We recognize that important considerations, such as the need to balance the goal of simplification with specific policy objectives and potential revenue constraints, make the process of achieving simplification of the present-law Federal tax system difficult. We hope that our study will help you prioritize your simplification objectives.

I thank the Subcommittees for the opportunity to present the Joint Committee staff recommendations on simplification of the Federal tax system and I welcome the opportunity to answer any questions you may have now or in the future.

EXECUTIVE SUMMARY OF A STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATION FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3)(B) OF THE INTERNAL REVENUE CODE OF 1986

PREPARED BY THE STAFF OF THE JOINT COMMITTEE ON TAXATION

A. Study Mandate and Methodology

Under the Internal Revenue Code, the Joint Committee on Taxation ("Joint Committee") is required to report, at least once each Congress, to the Senate Committee on Finance and the House Committee on Ways and Means on the overall state of the Federal tax system.[6] This study is required to include recommendations with respect to possible simplification proposals and such other matters relating to the administration of the Federal tax system as the Joint Committee may deem advisable.

In the course of this study, the Joint Committee staff:

(1) Undertook an extensive review of prior simplification proposals, including review of legal and economic literature making simplification and other legislative recommendations during the past 10 years; prior published and unpublished work of the Joint Committee staff with respect to simplification; various published Treasury studies; materials published by the National Taxpayer Ad-

---

[6] Internal Revenue Code ("Code") sec. 8022(3)(B). This provision was added by section 4002(a) of the Internal Revenue Service Restructuring and Reform Act of 1998 (Pub. L. No. 105–206). The requirement for a study stemmed from recommendations of the National Commission on Restructuring the Internal Revenue Service in 1997. Report of the Commission on Restructuring the Internal Revenue Service: *A Vision for a New IRS: Report of the National Commission on Restructuring the Internal Revenue Service*, June 27, 1997. Preparation of the Joint Committee study is subject to specific appropriations by the Congress. For fiscal year 2000, the staff of the Joint Committee on Taxation ("Joint Committee staff") advised the House and Senate Committees on Appropriations that an appropriation of $200,000 would be required for the Joint Committee staff to undertake the study and amounts were appropriated for this purpose.

vocate and the Commissioner of Internal Revenue, including the Tax Complexity Study issued by the Commissioner on June 5, 2000; and published simplification recommendations of various professional organizations, including the American Bar Association, the American Institute of Certified Public Accountants, and the Tax Executives Institute;

(2) Assembled two groups of advisors (approximately 40 academic advisors and approximately 25 individuals who previously held senior-level tax policy positions in the Federal government) to assist in the analysis of various simplification proposals and to solicit simplification ideas that may not have been previously advanced;

(3) Conducted a full-day meeting with representatives of the Internal Revenue Service ("IRS") to solicit comments and suggestions on specific issues under the Federal tax system and a separate meeting with the IRS and the Director of the American University Washington College of Law Tax Clinic on issues relating to the present-law earned income credit;

(4) Requested that the General Accounting Office provide information that would assist in measuring the effects of complexity on taxpayers, including the size of the Code, the number of forms, instructions, and publications, and taxpayer errors and requests for assistance to the IRS; and

(5) Requested the Congressional Research Service to provide information regarding legislative and regulatory activity relating to the Federal tax system and information on the efforts of foreign countries to simplify their tax laws.

The Joint Committee staff (1) collected background information on the Federal tax system, (2) identified the sources and effects of complexity in the present-law tax system, (3) identified provisions adding complexity to the present-law tax system, and (4) developed simplification recommendations.

B. Background Information on the Federal Tax System

The Joint Committee staff collected background information on the sources of complexity in the Federal tax law and data concerning the filing of tax forms, taxpayer assistance, and information on error rates and tax controversies. Some of the information collected by the Joint Committee staff (with the assistance of the General Accounting Office) included the following:

(6) Over 100 million individual income tax returns are filed annually on behalf of roughly 90 percent of the U.S. population;

(7) The Internal Revenue Code consists of approximately 1,395,000 words;

(8) There are 693 sections of the Internal Revenue Code that are applicable to individual taxpayers, 1,501 sections applicable to businesses, and 445 sections applicable to tax-exempt organizations, employee plans, and governments;

(9) As of June 2000, the Treasury Department had issued almost 20,000 pages of regulations containing over 8 million words;

(10) During 2000, the IRS published guidance for taxpayers in the form of 58 revenue rulings, 49 revenue procedures, 64 notices, 100 announcements, at least 2,400 private letter rulings and technical advice memoranda, 10 actions on decision, and 240 field service advice;

(11) For 1999, publications of the IRS included 649 forms, schedules, and separate instructions totaling more than 16,000 lines, 159 worksheets contained in IRS instructions to forms, and approximately 340 publications totaling more than 13,000 pages;

(12) A taxpayer filing an individual income tax return could be faced with a return (Form 1040) with 79 lines, 144 pages of instructions, 11 schedules totaling 443 lines (including instructions), 19 separate worksheets embedded in the instructions, and the possibility of filing numerous other forms (IRS Publication 17, Your Federal Income Tax (273 pages), lists 18 commonly used forms other than Form 1040 and its schedules);

(13) In 1997, of the more than 122 million individual income tax returns filed, nearly 69 million were filed on Form 1040, as opposed to Form 1040A, Form 1040EZ, or Form 1040PC;

(14) In 1999, taxpayers contacted the IRS for assistance approximately 117 million times, up from 105 million contacts in 1996; and

(15) The use of paid return preparers increased from 48 percent of returns filed in 1990 to 55 percent of returns filed in 1999 (a 27 percent increase) and the use of computer software for return preparation increased from 16 percent of returns filed in 1990 to 46 percent of returns filed in 1999 (a 188 percent increase).

C. Sources of Complexity in the Present-Law Federal Tax System

In the course of its study, the Joint Committee staff identified various sources of complexity in the present-law Federal tax system. No single source of complexity can be identified that is primarily responsible for the state of the present-law system. Rather, the Joint Committee staff found that, for any complex provision, a number of different sources of complexity might be identified.

Among these sources of complexity the Joint Committee staff identified are: (1) a lack of clarity and readability of the law; (2) the use of the Federal tax system to advance social and economic policies; (3) increased complexity in the economy; and (4) the interaction of Federal tax laws with State laws, other Federal laws and standards (such as Federal securities laws, Federal labor laws and generally accepted accounting principles), the laws of foreign countries, and tax treaties. The lack of clarity and readability of the law results from (1) statutory language that is, in some cases, overly technical and, in other cases, overly vague; (2) too much or too little guidance with respect to certain issues; (3) the use of temporary provisions; (4) frequent changes in the law; (5) broad grants of regulatory authority; (6) judicial interpretation of statutory and regulatory language; and (7) the effects of the Congressional budget process.

D. Effects of Complexity on the Federal Tax System

There are a number of ways in which complexity can affect the Federal tax system. Among the more commonly recognized effects are (1) decreased levels of voluntary compliance; (2) increased costs for taxpayers; (3) reduced perceptions of fairness in the Federal tax system; and (4) increased difficulties in the administration of tax laws. Although there is general agreement among experts that complexity has these adverse effects, there is no consensus on the most appropriate method of measuring the effects of complexity. The Joint Committee staff explored certain information that may be helpful in assessing the possible effects of complexity in the present-law Federal tax system.

It is widely reported that complexity leads to reduced levels of voluntary compliance. Complexity can create taxpayer confusion, which may affect the levels of voluntary compliance through inadvertent errors or intentional behavior by taxpayers. The Joint Committee staff found that it is not possible to measure the effects of complexity on voluntary compliance because (1) there has been no consistent measurement of the levels of voluntary compliance in more than a decade and (2) there is no generally agreed measure of changes in the level of complexity in the tax system over time.

Commentators also state that complexity of the Federal tax systems results in increased costs of compliance to taxpayers. The Joint Committee staff explored some of the commonly used measures of the costs of compliance, such as the estimate of time required to prepare tax returns, but found that there is no reliable measure of the change in costs of compliance. The Joint Committee staff did find, however, that individual taxpayers have significantly increased their use of tax return preparers, computer software for tax return preparation, and IRS taxpayer assistance over the last 10 years.

Complexity reduces taxpayers' perceptions of fairness of the Federal tax system by (1) creating disparate treatment of similarly situated taxpayers, (2) creating opportunities for manipulation of the tax laws by taxpayers who are willing and able to obtain professional advice, and (3) disillusioning taxpayers to Federal tax policy because of the uncertainty created by complex laws.

Finally, complexity makes it more difficult for the IRS to administer present law. Complex tax laws make it more difficult for the IRS to explain the law to taxpayers in a concise and understandable manner in forms, instructions, publications, and other guidance. In addition, the IRS is more likely to make mistakes in the assistance provided to taxpayers and in the application of the law.

E. Identifying Provisions Adding Complexity

In conducting this study, the Joint Committee staff looked at a variety of factors that contribute to complexity. Although the Joint Committee staff's focus was on complexity as it affects taxpayers (either directly or through the application of the law by tax practitioners), the Joint Committee staff also took into account complexity encountered by the IRS in administering the tax laws.

The Joint Committee staff generally did not take into account the level of sophistication of taxpayers or the complexity of transactions in identifying complex provisions; however, as discussed below, such factors were taken into account in making recommendations for simplification.

Factors the Joint Committee staff analyzed in identifying provisions that add complexity include the following:

(16) The existence of multiple provisions with similar objectives;

(17) The nature and extent of mathematical calculations required by a provision;

(18) Error rates associated with a provision;

(19) Questions frequently asked the IRS by taxpayers;

(20) The length of IRS worksheets, forms, instructions, and publications needed to explain and apply a provision;

(21) Recordkeeping requirements;

(22) The extent to which a provision results in disputes between the IRS and taxpayers;

(23) The extent to which a provision makes it difficult for taxpayers to plan and structure normal business transactions;

(24) The extent to which a provision makes it difficult for taxpayers to estimate and understand their tax liabilities;

(25) Whether a provision accomplishes its purposes and whether particular aspects of a provision are necessary to accomplish the purposes of the provision;

(26) Lack of consistency in definitions of similar terms;

(27) The extent to which a provision creates uncertainty;

(28) Whether a provision no longer serves any purpose or is outdated;

(29) Whether the statutory rules are easily readable and understandable;

(30) The extent to which major rules are provided in regulations and other guidance rather than in the Code; and

(31) The existence of appropriate administrative guidance.

F. Summary of Joint Committee Staff Recommendations

1. Overview

The Joint Committee staff analyzed each possible simplification recommendation from a variety of perspectives, including:

(32) The extent to which simplification could be achieved by the recommendation;

(33) Whether the recommendation improves the fairness or efficiency of the Federal tax system;

(34) Whether the recommendation improves the understandability and predictability (i.e., transparency) of the Federal tax system;

(35) The complexity of the transactions that would be covered by the recommendation and the sophistication of affected taxpayers;

(36) Administrative feasibility and enforceability of the recommendation;

(37) The burdens imposed on taxpayers, tax practitioners, and tax administrators by changes in the tax law; and

(38) Whether a provision of present law could be eliminated because it is obsolete or duplicative.

In developing possible simplification recommendations, the Joint Committee staff applied one overriding criterion: the Joint Committee staff would make a simplification recommendation only if the recommendation did not fundamentally alter the underlying policy articulated by the Congress in enacting the provision. As a result of applying this criterion, the Joint Committee staff did not make certain simplification recommendations reviewed in the course of this study. However, further simplification could be achieved by addressing certain of the policy decisions made in developing various provisions of present law.

Among the types of issues with respect to which the Joint Committee staff did not make specific simplification recommendations because of policy considerations are the following: (1) reducing the number of individual income tax filing statuses; (2) determining marital status; (3) reducing the number of exclusions from income; (4) making structural modifications to above-the-line deductions and itemized deductions; (5) increasing the standard deduction; (6) making structural changes to the dependency exemption, the child credit, and the earned income credit; (7) modifying the treatment of home mortgage interest of individuals; (8) modifying the distinction between ordinary income (and losses) and capital gains (and losses); (9) integrating the corporate and individual income tax; (10) altering the basic rules relating to corporate mergers and acquisitions; (11) eliminating the personal holding company and accumulated earnings tax provisions; (12) reducing the number of separate tax rules for different types of pass-through entities; (13) determining whether an expenditure is a capital expenditure that cannot be currently expensed; (14) modifying the rules relating to depreciation of capital assets; (15) providing uniform treatment of economically similar financial instruments; (16) modifying the rules relating to taxation of foreign investments; (17) modifications to the foreign tax credit; (18) altering the taxation of individual taxpayers with respect to cross border portfolio investments overseas; (19) changing the determination of an individual's status as an employee or independent contractor; (20) clarifying the treatment of limited partners for self-employment tax purposes; (21) providing alternative methods of return filing; and (22) eliminating overlapping jurisdiction of litigation relating to the Federal tax system.

The Joint Committee staff did not conclude that a simplification recommendation was inconsistent with the underlying policy of a provision merely because the recommendation might alter the taxpayers affected.

In some instances, the Joint Committee staff concluded that a provision did not accomplish the underlying policy articulated when the provision was enacted. In such instances, the Joint Committee staff concluded that recommending elimination or substantial modification of a provision was not inconsistent with the underlying policy.

2. Alternative minimum tax

The Joint Committee staff recommends that the individual and corporate alternative minimum taxes should be eliminated. The individual and corporate alternative minimum taxes contribute complexity to the present-law tax system by requiring taxpayers to calculate Federal income tax liability under two different systems.

The Joint Committee staff believes that the individual alternative minimum tax no longer serves the purposes for which it was intended. The present-law structure of the individual alternative minimum tax expands the scope of the provisions to taxpayers who were not intended to be alternative minimum tax taxpayers. The number of individual taxpayers required to comply with the complexity of the individual alternative minimum tax calculations will continue to grow due to the lack of indexing of the minimum tax exemption amounts and the effect of the individual alternative minimum tax on taxpayers claiming nonrefundable personal credits. By 2011, the Joint Committee staff projects that more than 11 percent of all individual taxpayers will be subject to the individual alternative minimum tax.

Furthermore, legislative changes since the Tax Reform Act of 1986 have had the effect of partially conforming the tax base for alternative minimum tax purposes to the tax base for regular tax purposes. Thus, the Joint Committee staff finds it appropriate to recommend that the alternative minimum tax be eliminated.

3. Individual income tax

Uniform definition of a qualifying child

The Joint Committee staff recommends that a uniform definition of qualifying child should be adopted for purposes of determining eligibility for the dependency exemption, the earned income credit, the child credit, the dependent care tax credit, and head of household filing status. Under this uniform definition, in general, a child would be a qualifying child of a taxpayer if the child has the same principal place of abode as the taxpayer for more than one half the taxable year. Generally, a "child" would be defined as an individual who is (1) the son, daughter, stepson, stepdaughter, brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any of such individuals, and (2) under age 19 (or under age 24 in the case of a student). As under present law, the child would have to be under age 13 for purposes of the dependent care credit. No age limit would apply in the case of disabled children. Adopted children, children placed with the taxpayer for adoption by an authorized agency, and foster children placed by an authorized agency would be treated as the taxpayer's child. A tie-breaking rule would apply if more than one taxpayer claims a child as a qualifying child. Under the tie-breaking rule, the child generally would be treated as a qualifying child of the child's parent.

Adopting a uniform definition of qualifying child would make it easier for taxpayers to determine whether they qualify for the various tax benefits for children and reduce inadvertent taxpayer errors arising from confusion due to different definitions of qualifying child. A residency test is recommended as the basis for the uniform definition because it is easier to apply than a support test.

This recommendation would provide simplification for substantial numbers of taxpayers. Under present law, it is estimated that, for 2001, 44 million returns will claim a dependency exemption for a child, 19 million returns will claim the earned income credit, 6 million returns will claim the dependent care credit, 26 million returns will claim the child credit, and 18 million returns will claim head of household filing status.

Dependent care benefits

The Joint Committee staff recommends that the dependent care credit and the exclusion for employer-provided dependent care assistance should be conformed by: (1) providing that the amount of expenses taken into account for purposes of the dependent care credit is the same flat dollar amount that applies for purposes of the exclusion (i.e., $5,000 regardless of the number of qualifying individuals); (2) eliminating the reduction in the credit for taxpayers with adjusted gross income above certain levels; and (3) providing that married taxpayers filing separate returns are eligible for one half the otherwise applicable maximum credit.

The recommendation would eliminate the confusion caused by different rules for the two present-law tax benefits allowable for dependent care expenses. The recommendation also would simplify the dependent care credit by eliminating features of the credit that require additional calculations by taxpayers.

This recommendation could provide simplification for as many as 6 million returns, the number of returns estimated to claim the dependent care credit in 2001.

Earned income credit

The Joint Committee staff recommends that the earned income credit should be modified as follows: (1) the uniform definition of qualifying child (including the tie-breaking rule) recommended by the Joint Committee staff should be adopted for purposes of the earned income credit; and (2) earned income should be defined to include wages, salaries, tips, and other employee compensation to the extent includible in gross income for the taxable year, and net earnings from self employment.

Applying the uniform definition of child recommended by the Joint Committee staff to the earned income credit would make it easier for taxpayers to determine whether they qualify for the earned income credit and would reduce inadvertent errors caused by different definitions. The elimination of nontaxable compensation from the definition of earned income would alleviate confusion as to what constitutes earned income and enable taxpayers to determine earned income from information already included on the tax return.

This recommendation could provide simplification for as many as 19 million returns, the number of returns estimated to claim the credit in 2001.

Head of household filing status

The Joint Committee staff recommends that head of household filing status should be available with respect to a child only if the child qualifies as a dependent of the taxpayer under the Joint Committee staff's recommended uniform definition of qualifying child. Applying the uniform definition of child recommended by the Joint Committee staff would make it easier for taxpayers to determine if they are eligible for head of household status due to a child and reduce taxpayer errors due to differing definitions of qualifying child.

This recommendation could provide simplification for up to 18 million returns that are estimated to be filed in 2001 using head of household filing status.

Surviving spouse status

The Joint Committee staff recommends that surviving spouse status should be available only for one year and that the requirement that the surviving spouse have a dependent should be eliminated. The recommendation would eliminate confusion about who qualifies for surviving spouse status.

Phase-outs and phase-ins

The Joint Committee staff recommends that the following phase-outs should be eliminated: (1) overall limitation on itemized deductions (known as the "PEASE" limitation); (2) phase-out of personal exemptions (known as "PEP"); (3) phase-out of child credit; (4) partial phase-out of the dependent care credit; (5) phase-outs relating to individual retirement arrangements; (6) phase-out of the HOPE and Lifetime Learning credits; (7) phase-out of the deduction for student loan interest; (8) phase-out of the exclusion for interest on education savings bonds; and (9) phase-out of the adoption credit and exclusion.

These phase-outs require taxpayers to make complicated calculations and make it difficult for taxpayers to plan whether they will be able to utilize the tax benefits subject to the phase-outs. Eliminating the phase-outs would eliminate complicated calculations and make planning easier. These phase-outs primarily address progressivity, which can be more simply addressed through the rate structure.

This recommendation would provide simplification for up to 30 million returns that are subject to one or more of the present law phase-outs and phase-ins.

Taxation of Social Security benefits

The Joint Committee staff recommends that the amount of Social Security benefits includible in gross income should be a fixed percentage of benefits for all taxpayers. The Joint Committee staff further recommends that the percentage of includible benefits should be defined such that the amount of benefits excludable from income approximates individuals' portion of Social Security taxes. The recommendation would eliminate the complex calculations and 18-line worksheet currently required in order to determine the correct amount of Social Security benefits includible in gross income. This recommendation could provide simplification for as many as 12 million returns that show taxable Social Security benefits; 5.7 million of such returns are in the income phase-out range.

Individual capital gains and losses

The Joint Committee staff recommends that the current rate system for capital gains should be replaced with a deduction equal to a fixed percentage of the net capital gain. The deduction should be available to all individuals. The recommendation would simplify the computation of the taxpayer's tax on capital gains and streamline the capital gains tax forms and schedules for individuals for as many as 27 million returns estimated to have capital gains or losses in 2001.

The Joint Committee staff recommends that, for purposes of ordinary loss treatment under sections 1242 and 1244, the definition of small business should be conformed to the definition of small business under section 1202, regardless of the date of issuance of the stock. The recommendation would reduce complexity by conforming the definition of small business that applies for purposes of preferential treatment of capital gain or loss.

Two-percent floor on miscellaneous itemized deductions

The Joint Committee staff recommends that the two-percent floor applicable to miscellaneous itemized deductions should be eliminated. The Joint Committee staff finds that the two-percent floor applicable to miscellaneous itemized deductions has added to complexity because it has: (1) placed pressure on individuals to claim that they are independent contractors, rather than employees; (2) resulted in extensive litigation with respect to the proper treatment of certain items, such as attorneys' fees; (3) resulted in inconsistent treatment with respect to similar items of expense; and (4) created pressure to enact deductions that are not subject to the floor. Although the two-percent floor was enacted, in part, to reduce complexity, it has instead shifted complexity to these other issues relating to miscellaneous itemized deductions.

Provisions relating to education

Definition of qualifying higher education expenses

The Joint Committee staff recommends that a uniform definition of qualifying higher education expenses should be adopted. A uniform definition would eliminate the need for taxpayers to understand multiple definitions if they use more than one education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions.

Combination of HOPE and Lifetime Learning credits

The Joint Committee staff recommends that the HOPE and Lifetime Learning credits should be combined into a single credit. The single credit would: (1) utilize the present-law credit rate of the Lifetime Learning credit; (2) apply on a per-student basis; and (3) apply to eligible students as defined under the Lifetime Learning credit.

Combining the two credits would reduce complexity and confusion by eliminating the need to determine which credit provides the greatest benefit with respect to one individual and to determine if a taxpayer can qualify for both credits with respect to different individuals.

Interaction among education tax incentives

The Joint Committee staff recommends that restrictions on the use of education tax incentives based on the use of other education tax incentives should be eliminated and replaced with a limitation that the same expenses could not qualify under more than one provision. The recommendation would eliminate the complicated planning required in order to obtain full benefit of the education tax incentives and reduce traps for the unwary. The recommendation would eliminate errors by taxpayers due to the provisions that trigger adverse consequences as a result of actions by persons other than the taxpayer.

Student loan interest deduction

The Joint Committee staff recommends that the 60-month limit on deductibility of student loan interest should be eliminated. The recommendation would make determining the amount of deductible interest easier because taxpayers would not need to determine the history of the loan's payment status.

Exclusion for employer-provided educational assistance

The Joint Committee staff recommends that the exclusion for employer-provided educational assistance should be made permanent. The recommendation would reduce administrative burdens on employers and employees caused by the present practice of allowing the exclusion to expire and then extending it. The recommendation would make it easier for employees to plan regarding education financing. The recommendation would eliminate the need to apply a facts and circumstances test to determine if education is deductible in the absence of the exclusion.

Taxation of minor children

The Joint Committee staff recommends that the tax rate schedule applicable to trusts should be applied with respect to the net unearned income of a child taxable at the parents' rate under present law. In addition, the Joint Committee staff recommends that the parental election to include a child's income on the parents' return should be available irrespective of (1) the amount and type of the child's income, and (2) whether withholding occurred or estimated tax payments were made with respect to the child's income. Utilizing the trust rate schedule would eliminate the complexity arising from the linkage of the returns of parent, child, and siblings. Expanding the parental election would decrease the number of separate returns filed by children.

4. Individual retirement arrangements, qualified retirement plans, and employee benefits

Individual retirement arrangements ("IRAs")

The Joint Committee staff recommends that the income limits on eligibility to make deductible IRA contributions, Roth IRA contributions, and conversions of traditional IRAs to Roth IRAs should be eliminated. Further, the Joint Committee staff recommends that the ability to make nondeductible contributions to traditional IRAs should be eliminated. The Joint Committee staff recommends that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs.

The IRA recommendations would reduce the number of IRA options and conform eligibility criteria for remaining IRAs, thus simplifying taxpayers' savings decisions.

Recommendations relating to qualified retirement plans

Definition of compensation

The Joint Committee staff recommends that: (1) a single definition of compensation should be used for all qualified retirement plan purposes, including determining plan benefits, and (2) compensation should be defined as the total amount that the employer is required to show on a written statement to the employee, plus elective deferrals and contributions for the calendar year. The recommendation would eliminate the need to determine different amounts of compensation for various purposes or periods.

Nondiscrimination rules for qualified plans

The Joint Committee staff recommends that: (1) the ratio percentage test under the minimum coverage rules should be modified to allow more plans to use the test, (2) excludable employees should be disregarded in applying the minimum coverage and general nondiscrimination rules, and (3) the extent to which cross-testing may be used should be specified in the Code. The first recommendation would simplify minimum coverage testing by eliminating the need for some plans to perform the complex calculations required under the average benefit percentage test. The second recommendation would simplify nondiscrimination testing by eliminating the need to analyze the effect of covering excludable employees under the plan. The third recommendation would provide certainty and stability in the design of qualified retirement plans that rely on cross-testing by eliminating questions as to whether and to what extent the cross-testing option is available.

Vesting requirements

The Joint Committee staff recommends that the vesting requirements for all qualified retirement plans should be made uniform by applying the top-heavy vesting schedules to all plans. A single set of vesting rules would provide consistency among plans and will reduce complexity in plan documents and in the determination of vested benefits.

SIMPLE plans

The Joint Committee staff recommends that the rules relating to SIMPLE IRAs and SIMPLE 401(k) plans should be conformed by (1) allowing State and local government employers to adopt SIMPLE 401(k) plans, (2) applying the same contribution rules to SIMPLE IRAs and SIMPLE 401(k) plans, and (3) applying the employee eligibility rules for SIMPLE IRAs to SIMPLE 401(k) plans. This recommendation would make choosing among qualified retirement plan designs easier for all small employers.

Definitions of highly compensated employee and owner

The Joint Committee staff recommends that uniform definitions of highly compensated employee and owner should be used for all qualified retirement plan and employee benefit purposes. Uniform definitions would eliminate multiple definitions of highly compensated employee and owner for various purposes, thereby allowing employers to make a single determination of highly compensated employees and owners.

Contribution limits for tax-sheltered annuities

The Joint Committee staff recommends that the contribution limits applicable to tax-sheltered annuities should be conformed to the contribution limits applicable to comparable qualified retirement plans. Conforming the limits would reduce the recordkeeping and computational burdens related to tax-sheltered annuities and eliminate confusing differences between tax-sheltered annuities and qualified retirement plans.

Minimum distribution rules

The Joint Committee staff recommends that the minimum distribution rules should be simplified by providing that: (1) no distributions are required during the life of a participant; (2) if distributions commence during the participant's lifetime under an annuity form of distribution, the terms of the annuity will govern distributions after the participant's death; and (3) if distributions either do not commence during the participant's lifetime or commence during the participant's lifetime under a nonannuity form of distribution, the undistributed accrued benefit must be distributed to the participant's beneficiary or beneficiaries within five years of the participant's death. The elimination of minimum required distributions during the life of the participant and the establishment of a uniform rule for post-death distributions would significantly simplify compliance by plan participants and their beneficiaries, as well as plan sponsors and administrators.

Exceptions to the early withdrawal tax; half-year conventions

The Joint Committee staff recommends that the exceptions to the early withdrawal tax should be uniform for all tax-favored retirement plans and that the applicable age requirements for the early withdrawal tax and permissible distributions from section 401(k) plans should be changed from age 59–1/2 to age 55. Uniform rules for distributions would make it easier for individuals to determine whether distributions are permitted and whether distributions will be subject to the early withdrawal tax.

Allow all governmental employers to maintain section 401(k) plans

The Joint Committee staff recommends that all State and local governments should be permitted to maintain section 401(k) plans. This will eliminate distinctions between the types of plans that may be offered by different types of employers and simplify planning decisions.

Redraft provisions dealing with section 457 plans

The Joint Committee staff recommends that the statutory provisions dealing with eligible deferred compensation plans should be redrafted so that separate provisions apply to plans maintained by State and local governments and to plans maintained by tax-exempt organizations. This will make it easier for employers to understand and comply with the requirements applicable to their plans.

Attribution rules

The Joint Committee staff recommends that the attribution rules used in determining controlled group status under section 1563 should be used in determining ownership for all qualified retirement plan purposes. Uniform attribution rules would enable the employer to perform a single ownership analysis for all relevant qualified retirement plan purposes.

Basis recovery rules for qualified retirement plans and IRAs

The Joint Committee staff recommends that a uniform basis recovery rule should apply to distributions from qualified retirement plans, traditional IRAs, and Roth IRAs. Under this uniform rule, distributions would be treated as attributable to basis first, until the entire amount of basis has been recovered. The uniform basis recovery rule would eliminate the need for individuals to calculate the portion of distributions attributable to basis and would apply the same basis recovery rule to all types of tax-favored retirement plans.

Modifications to employee benefit plan provisions

Cafeteria plan elections

The Joint Committee staff recommends that the frequency with which employees may make, revoke, or change elections under cafeteria plans should be determined under rules similar to those applicable to elections under cash or deferred arrangements. Applying simpler election rules to cafeteria plans would reduce confusion and administrative burdens for employers and employees.

Excludable employees

The Joint Committee staff recommends that a uniform definition of employees who may be excluded for purposes of the application of the nondiscrimination requirements relating to group-term life insurance, self-insured medical reimbursement plans, educational assistance programs, dependent care assistance programs, miscellaneous fringe benefits, and voluntary employees' beneficiary associations should be adopted. A uniform definition of excludable employees would eliminate minor distinctions that exist under present law and make nondiscrimination testing easier.

5. Corporate income tax

Collapsible corporations

The Joint Committee staff recommends that the collapsible corporation provisions should be eliminated. This recommendation would eliminate a complex provision that became unnecessary with the enactment of the corporate liquidation rules of the Tax Reform Act of 1986.

Active business requirement of section 355

The Joint Committee staff recommends that the active business requirement of section 355 should be applied on an affiliated group basis. Thus, the "substantially all" test should be eliminated. This recommendation would simplify business planning for corporate groups that use a holding company structure.

Uniform definition of a family

The Joint Committee staff recommends that a uniform definition of a family should be used in applying the attribution rules used to determine stock ownership. For this purpose, a "family" should be defined as including brothers and sisters (other than step-brothers and step-sisters), a spouse (other than a spouse who is legally separated from the individual under a decree of divorce whether interlocutory or final, or a decree of separate maintenance), ancestors and lineal descendants. An exception would be provided with respect to limiting multiple tax benefits in the case of controlled corporations (section 1561), in which case the present-law rules of section 1563(e) would be retained. A single definition of a family would eliminate many of the inconsistencies in the law that have developed over time and would reflect currently used agreements relating to divorce and separation.

Redemption through use of related corporations (section 304)

The Joint Committee staff recommends that section 304 should apply only if its application results in a dividend (other than a dividend giving rise to a dividends received deduction). The recommendation would limit the application of a complex set of rules.

Corporate reorganizations

The Joint Committee staff recommends that assets acquired in a tax-free reorganization pursuant to section 368(a)(1)(D) or 368(a)(1)(F) should be allowed to be transferred to a controlled subsidiary without affecting the tax-free status of the reorganization. This recommendation would harmonize the rules regarding post-reorganization transfers to controlled subsidiaries and eliminate the present-law uncertainties with respect to such transfers.

The Joint Committee staff recommends that the rules relating to the treatment of property received by a shareholder in reorganizations involving corporations under common control or a single corporation (or a section 355 transaction) should be conformed to the rules relating to the redemption of stock. This recommendation would simplify business planning by conforming the rules for determining dividend treatment if a continuing shareholder receives cash or other "boot" in exchange for a portion of the shareholder's stock.

Corporate redemptions

The Joint Committee staff recommends that a stock redemption incident to a divorce should be treated as a taxable redemption of the stock of the transferor spouse, unless both parties agree in writing that the stock is to be treated as transferred to the other spouse prior to the redemption. If one spouse actually receives a distribution and purchases the other spouse's stock, the form of the transaction would be respected. The recommendation would eliminate uncertainty and litigation regarding the treatment of the parties when a corporate stock redemption occurs incident to a divorce.

6. Pass-through entities

Partnerships

The Joint Committee staff recommends that references in the Code to "general partners" and "limited partners" should be modernized consistent with the purpose of the reference. In most cases, the reference to limited partners could be updated by substituting a reference to a person whose participation in the management or business activity of the entity is limited under applicable State law (or, in the case of general partners, not limited). In a few cases, the reference to limited partners could be retained because the provisions also refer to a person (other than a limited partner) who does not actively participate in the management of the enterprise, which can encompass limited liability company owners with interests similar to limited partnership interests. In one case, the reference to a general partner can be updated by referring to a person with income from the partnership from his or her own personal services. The recommendation would provide simplification by modernizing these references to accommodate limited liability companies, whose owners generally are partners within the meaning of Federal tax law, but are not either general partners or limited partners under State law.

The Joint Committee staff recommends that the special reporting and audit rules for electing large partnerships should be eliminated and that large partnerships should be subject to the general rules applicable to partnerships. The recommendation would simplify the reporting and audit rules by eliminating the least-used sets of rules.

The Joint Committee staff recommends that the timing rules for guaranteed payments to partners and for transactions between partnerships and partners not acting in their capacity as such should be conformed. The timing rule for all such payments and transactions should be based on the time the partnership takes the payment into account. The recommendation would provide simplification by eliminating one of two conflicting timing rules applicable to similar types of situations.

S corporations

The Joint Committee staff recommends that the special termination rule for certain S corporations with excess passive investment income should be eliminated. In addition, the corporate-level tax on excess passive investment income should be modified so that the tax would be imposed only on an S corporation with accumulated earnings and profits in any year in which more than 60 percent (as opposed to 25 percent) of its gross income is considered passive investment income. The recommendation would eliminate much of the uncertainty and complexity of present law for S corporations that are required to characterize their income as active or passive income, and at the same time would conform the tax with the personal holding company rules applicable to C corporations (that address a similar concern).

The Joint Committee staff recommends that the special rules for the taxation of electing small business trusts should be eliminated and that the regular rates of Subchapter J should apply to these trusts and their beneficiaries. Under this recommendation, no election to be a qualified subchapter S trust could be made in the future. The recommendation would eliminate some of the complexity regarding the operating rules for electing small business trusts as well as the overlapping rules for electing small business trusts and qualified Subchapter S trusts.

7. General business issues

Like-kind exchanges

The Joint Committee staff recommends that a taxpayer should be permitted to elect to rollover gain from the disposition of appreciated business or investment property described in section 1031 if like-kind property is acquired by the taxpayer within 180 days before or after the date of the disposition (but not later than the due date of the taxpayer's income tax return). The determination of whether properties are considered to be of a "like-kind" would be the same as under present law.

The Joint Committee staff recommends that, for purposes of determining whether property satisfies the holding period requirement for a like-kind exchange, a taxpayer's holding period and use of property should include the holding period and use of property by the transferor in the case of property (1) contributed to a corporation or partnership in a transaction described in section 351 or 721, (2) acquired by a corporation in connection with a transaction qualifying as a reorganization under section 368, (3) distributed by a partnership to a partner, and (4) distributed by a corporation in a transaction to which section 332 applies. In addition, the Joint Committee staff recommends that property whose use changes should not qualify for like-kind exchange treatment unless it is held for productive use in a trade or business or investment for a specified period of time.

The recommendation would reduce complexity by allowing taxpayers to reinvest the proceeds from the sale of business or investment property into other like-kind property directly without engaging in complicated "exchanges" designed to meet the statutory and regulatory rules regarding deferred exchanges. In addition, the recommendation would remove the confusion and uncertainty under section 1031 with respect to whether a taxpayer is considered to hold property for productive use in a trade or business or for investment when the property has been recently transferred.

Low-income housing tax credit

The Joint Committee staff recommends that the payout period for the low-income housing tax credit should be conformed to the initial compliance period (15 years). This recommendation would eliminate the present-law credit recapture rules, which are a significant source of complexity for the credit.

Rehabilitation tax credit

The Joint Committee staff recommends that the 10-percent credit for rehabilitation expenditures with respect to buildings first placed in service before 1936 should be eliminated. Thus, the rehabilitation credit would not be a two-tier credit, but instead would provide only a 20-percent credit with respect to certified historic structures.

The recommendation would achieve simplification in two respects. First, it would eliminate the overlapping categories of "old" and "historic" buildings eligible for different levels of credit under present law. Second, it would eliminate the record-keeping burden currently imposed under the 10-percent credit.

Orphan drug tax credit

The Joint Committee staff recommends that the definition of qualifying expenses for the orphan drug tax credit should be expanded to include expenses related to human clinical testing incurred after the date on which the taxpayer files an application with the Food and Drug Administration for designation of the drug under section 526 of the Federal Food, Drug, and Cosmetic Act as a potential treatment for a rare disease or disorder. As under present law, the credit could only be claimed for such expenses related to drugs designated as a potential treatment for a rare disease or disorder by the Food and Drug Administration in accordance with section 526 of such Act. The recommendation would reduce complexity by treating all human clinical trial expenses in the same manner for purposes of the credit and any allowable deduction.

Work opportunity tax credit and welfare-to-work tax credit

The Joint Committee staff recommends that the work opportunity tax credit and welfare-to-work tax credit should be combined and subject to a single set of rules. The combined credit would be simpler for employers because they would use a single set of requirements when hiring individuals from all the targeted groups of potential employees.

Indian employment credit

The Joint Committee staff recommends that the Indian employment credit should be calculated without reference to amounts paid by the employer in 1993. Eliminating the incremental aspect of the credit would reduce the record retention burden on taxpayers in the event the credit is extended permanently.

Reduced emissions vehicles

The Joint Committee staff recommends that the tax benefit for reduced emissions vehicles should be a deduction of qualified expenses related to all such qualifying vehicles, provided that the Congress chooses to extend the tax benefits applicable to such vehicles. Fewer tax benefit options for a similar policy goal would simplify taxpayer decision making and promote a uniform incentive.

8. Accounting provisions

Cash method of accounting

The Joint Committee staff recommends that a taxpayer with less than $5 million of average annual gross receipts should be permitted to use the cash method of accounting and should not be required to use an accrual method of accounting for purchases and sales of merchandise under section 471. A taxpayer that elects not to account for inventory under section 471 would be required to treat inventory as a material or supply that is deductible only in the amount that it is actually consumed and used in operations during the tax year. The recommendation would not apply to tax shelters and would not alter the rules for family farm corporations. The recommendation would enlarge the class of businesses that can use the cash method of accounting, which is a simpler method of accounting. Such businesses would have reduced recordkeeping requirements and would not need to understand the requirements associated with an accrual method of accounting.

Organizational costs

The Joint Committee staff recommends that the rules and requirements to elect to amortize organizational costs should be codified in a single Code provision irrespective of the choice of entity chosen by the taxpayer. In addition, organizational costs incurred in the formation of entities that are, or are elected to be, disregarded for Federal income tax purposes would be eligible to recover organization costs over 60 months. The recommendation would consolidate the rules governing the treatment of organizational costs for all types of entities into one provision and would clarify the tax treatment of organizational costs incurred with respect to legal entities that are disregarded for Federal income tax purposes.

Mid-quarter convention for depreciation

The Joint Committee staff recommends that the mid-quarter convention for depreciable property should be eliminated. This calculation, which requires an analysis of property placed in service during the last three months of any taxable year, can be complex and burdensome because taxpayers must wait until after the end of the taxable year to determine the proper placed-in-service convention for calculating depreciation for its assets during the taxable year. The recommendation would simplify the rules for calculating depreciation, because an analysis of property would no longer need to be performed with respect to property placed in service during the last three months of a taxable year to determine application of the mid-quarter convention.

9. Financial products and institutions

Straddle rules

The Joint Committee staff recommends that the general loss deferral rule of the straddle rules should be modified to allow the identification of offsetting positions that are components of a straddle at the time the taxpayer enters into a transaction that creates a straddle, including an unbalanced straddle. Straddle period losses would be allocated to the identified offsetting positions in proportion to the offsetting straddle period gains and would be capitalized into the basis of the offsetting position.

The Joint Committee staff recommends that the exception for stock in the definition of personal property should be eliminated. Thus, offsetting positions involving actively traded stock generally would constitute a straddle.

Modifying the general loss deferral rule to permit identification of offsetting positions in a straddle would eliminate an additional level of complexity and uncertainty encountered by taxpayers in applying the loss deferral rules to straddles, particularly unbalanced straddles. Similarly, eliminating the stock exception would simplify the straddle rules by eliminating an exception that has become very complex in practice and only applies to a narrow class of transactions.

Interest computation

The Joint Committee staff recommends that the eight different regimes for imposing interest on deferred taxes should be consolidated into three separate regimes: (1) an annual interest charge rule; (2) a look-back rule in which estimates are used;

and (3) a look-back rule in which the tax is allocated to prior years based on the applicable Federal rate. The interest rate that would be applied in connection with the three separate regimes would be a uniform rate. Consolidating the interest charge rules would reduce complexity by providing a more uniform application of rules that fulfill the same policy of imposing interest on the deferral of tax. Computing the interest charges at a uniform rate would further reduce the complexity of interest charges.

Taxation of annuities

The Joint Committee staff recommends that section 72, relating to taxation of annuities, should be redrafted to eliminate overly convoluted language and improve the readability of the statutory language. The Joint Committee staff provides a recommended redraft of a portion of section 72 for public review and comment.

In addition, the Joint Committee staff recommends that the provisions of section 72 that apply to qualified retirement plans should be separated from the other provisions of section 72 and combined with the other rules governing the taxation of distributions from such plans. The recommendations would provide simplification by improving the readability of the provisions and by grouping related provisions together so they can be more easily found and understood.

Insurance companies

The Joint Committee staff recommends that the special rules permitting a deduction for certain reserves for mortgage guaranty insurance, lease guaranty insurance, and insurance of State and local obligations should be eliminated. The recommendation would reduce complexity by eliminating tax rules that principally serve a financial accounting purpose.

The Joint Committee staff recommends that the special rules provided to Blue Cross and Blue Shield organizations in existence on August 16, 1986, should be eliminated. Appropriate rules would be provided for taking into account items arising from the resulting change in accounting method for tax purposes. Complexity would be reduced by eliminating special rules that are based on historical facts and that are of declining relevance to the tax treatment of health insurers.

The Joint Committee staff recommends that the two five-year rules relating to consolidated returns of affiliated groups including life insurance companies and nonlife insurance companies should be eliminated. Appropriate conforming rules should be provided. The complexity both to the acquired corporations and the existing members of the affiliated group in corporate acquisitions involving life insurance and nonlife insurance companies would be reduced, with respect to recordkeeping and with respect to calculation of tax liability.

10. International provisions

Foreign personal holding companies, personal holding companies, and foreign investment companies

The Joint Committee staff recommends that (1) the rules applicable to foreign personal holding companies and foreign investment companies should be eliminated, (2) foreign corporations should be excluded from the application of the personal holding company rules, and (3) subpart F foreign personal holding company income should include certain personal services contract income targeted under the present-law foreign personal holding company rules. The recommendation would provide relief from the complex multiple sets of overlapping anti-deferral regimes that potentially apply to U.S. owners of stock in a foreign corporation.

Subpart F de minimis rule

The Joint Committee staff recommends that the subpart F de minimis rule should be modified to be the lesser of five percent of gross income or $5 million (increased from the present-law dollar threshold of $1 million). For taxpayers with relatively modest amounts of subpart F income, the recommendation would provide relief from the complexity and compliance burdens involved in separately accounting for income under the subpart F anti-deferral rules.

Look-through rule for 10/50 companies

The Joint Committee staff recommends that, for foreign tax credit limitation purposes, the look-through approach should be immediately applied to all dividends paid by a 10/50 company (regardless of the year in which the earnings and profits were accumulated). The recommendation would provide relief from recordkeeping burdens on U.S. corporations required to account for dividends paid by a 10/50 company under both the single basket limitation approach and the look-through approach.

Deemed-paid foreign tax credits

The Joint Committee staff recommends that a domestic corporation should be entitled to claim deemed-paid foreign tax credits with respect to a foreign corporation that is held indirectly through a foreign or U.S. partnership, provided that the domestic corporation owns (indirectly through the partnership) 10 percent or more of the foreign corporation's voting stock. The recommendation would clarify uncertainty in the law that may exist with respect to the application of the indirect foreign tax credit rules when a partner indirectly owns an interest in a foreign corporation through a partnership.

Section 30A and section 936

The Joint Committee staff recommends that, if the credits under section 30A and section 936 are extended (these provisions will expire after 2005), consideration should be given to conforming the application of the credit across all possessions and to combining the rules in one Code section. The recommendation would improve the readability of the rules for potential credit claimants with operations in Puerto Rico and other U.S. possessions by consolidating similar requirements for claiming such credits in one Code section.

Uniform capitalization rules

The Joint Committee staff recommends that in lieu of the uniform capitalization rules, costs incurred in producing property or acquiring property for resale should be capitalized using U.S. generally accepted accounting principles for purposes of determining a foreign person's earnings and profits and subpart F income. The uniform capitalization rules would continue to apply to foreign persons for purposes of determining income effectively connected with a U.S. trade or business. The recommendation would relieve taxpayers and the IRS from the compliance and enforcement burdens associated with applying the uniform capitalization adjustments in the context of certain foreign activities.

Secondary withholding tax

The Joint Committee staff recommends that the secondary withholding tax with respect to dividends paid by certain foreign corporations should be eliminated. The recommendation would spare taxpayers the burden of having to understand and comply with rules that have limited applicability, and relieve the IRS of the difficult task of trying to enforce the tax against a foreign corporation with little or no assets in the United States.

Tax on certain U.S.-source capital gains of nonresident individuals

The Joint Committee staff recommends that the 30-percent tax on certain U.S.-source capital gains of nonresident individuals should be eliminated. The recommendation would spare nonresident individuals with U.S. investments the burden of having to understand and comply with a rule that has limited applicability.

Treaties

The Joint Committee staff recommends that the Secretary of the Treasury should update and publish U.S. model tax treaties at least once each Congress. The recommendation would help inform potentially affected taxpayers of the Administration's current treaty policy goals, afford affected taxpayers the opportunity to offer more helpful commentary to treaty policy makers, and enable affected taxpayers to make more informed assessments regarding investments in countries in which treaty negotiations are being carried out.

The Joint Committee staff recommends that the Treasury should report to the Congress on the status of older U.S. tax treaties at least once each Congress. The recommendation would establish a process for renewing older U.S. tax treaties that may not reflect current policy and that provide different tax outcomes than do more recent U.S. tax treaties. Timely updates of U.S. tax treaties would reduce complexity that may arise for taxpayers and tax administrators as any one taxpayer may be subject to multiple different tax regimes on otherwise similar transactions by reason of the transactions involving different taxing jurisdictions with different treaties.

11. Tax-exempt organizations

Grass-roots lobbying

The Joint Committee staff recommends that the separate expenditure limitation on grass-roots lobbying by certain tax-exempt organizations should be eliminated. Eliminating this limitation would relieve charities making the section 501(h) election of the need to define and allocate expenses for grass-roots lobbying as a subset of total lobbying expenditures. This would simplify the Code and regulations by eliminating a largely unnecessary, but burdensome, process of definition and calculation.

Excise tax based on investment income

The Joint Committee staff recommends that the excise tax based on the investment income of private foundations should be eliminated. The recommendation would relieve private foundations of having to calculate net investment income, to make estimated tax payments, and to consider whether annual charitable distributions should be increased or decreased because of the two-tiered nature of the tax. In addition, taxable foundations would not be required to calculate the unrelated business income tax they would have been required to pay if they were a taxable organization. Short of elimination, the tax could be revised to generate less revenue and at the same time become less complex, for example, by basing the tax on a percentage of the value of a private foundation's assets at the end of a taxable year.

12. Farming, distressed communities, and energy provisions

Conservation payments

The Joint Committee staff recommends that the Code should be amended to reflect that the agricultural conservation program authorized by the Soil Conservation and Domestic Allotment Act has been replaced by the Environmental Quality Incentives Program. The recommendation would clarify that cost-sharing payments under the Environmental Quality Incentives Program are excludable from gross income.

Reforestation expenses

The Joint Committee staff recommends that the separate seven-year amortization and tax credit for $10,000 of reforestation expenses should be replaced with expensing of a specified amount of reforestation expenses. Expensing could provide approximately the same tax benefit for qualified reforestation expenditures without requiring two distinct calculations and without requiring the additional recordkeeping to carry forward the taxpayer's unamortized basis in the expenditures through eight taxable years.

Sales of timber qualifying for capital gains treatment

The Joint Committee staff recommends that (1) the sale of timber held more than one year by the owner of the land from which the timber is cut should be entitled to capital gain treatment and (2) the provision relating to a retained economic interest should be eliminated. The recommendation would eliminate the need to make subjective determinations of dealer status with respect to sales of timber and would eliminate a source of controversy and litigation.

District of Columbia ("D.C.") Enterprise Zone

The Joint Committee staff recommends that, if the D.C. Enterprise Zone is to be extended for a significant period of time, then the poverty rates and the gross income thresholds applicable to the zero-percent capital gains rate should be conformed to the poverty rates and gross income thresholds that apply to the other tax incentives with respect to the D.C. Enterprise Zone. Thus, the Joint Committee staff recommends that a new business should qualify for the zero-percent capital gains rate if (1) more than 50 percent (rather than 80 percent) of its gross income is from the active conduct of a qualified business within the zone, and (2) the business is located in census tracts with at least a 20-percent (rather than 10 percent) poverty rate. The recommendations would eliminate much of the confusion, as well as traps for the unwary, for businesses that locate in the D.C. Enterprise Zone by providing a single gross income and single poverty test for determining whether a new business qualifies for the various tax incentives.

Tax incentives for business located in targeted geographic areas

The Joint Committee staff recommends that a uniform package of tax incentives for businesses that locate in targeted geographic areas should be adopted. In addition, the targeted geographic areas that would be eligible for the tax incentives would be determined based on the application of a consistent set of economic measurements. The recommendation would eliminate many of the complexities that exist under present law for businesses in determining where to locate its business facilities, and for the Treasury, the IRS, and State and local agencies in selecting the distressed areas complying with the tax laws and monitoring the effectiveness of the tax incentives.

Geological and geophysical costs

The Joint Committee staff recommends that taxpayers should be permitted immediate expensing of geological and geophysical costs. The recommendation would reduce complexity by eliminating the need to allocate such expenses to various properties and by eliminating the need to make factual determinations relating to the properties, such as what constitutes an area of interest and when a property is abandoned.

13. Excise taxes

Highway Trust Fund excise taxes

The Joint Committee staff recommends that the number of taxes imposed to finance Highway Trust Fund programs should be reduced by eliminating or consolidating the non-fuels taxes. The rates at which the fuels taxes or the restructured non-fuels taxes are imposed could be adjusted to ensure that future funding for Trust Fund programs is not affected. Adoption of this recommendation would reduce the number of taxpayers having direct involvement with the highway excise taxes. Further, the non-fuels taxes are heavily dependent on factual determinations; their elimination would end numerous audit issues between taxpayers and the IRS.

The Joint Committee staff recommends that the definition of highway vehicle should be clarified to eliminate taxpayer uncertainty about the taxability of motor fuels and retail sales (if the retail sales tax is retained). Enacting a single definition of highway vehicle would provide certainty to taxpayers.

The Joint Committee staff recommends that the option to pay the heavy vehicle annual use tax in quarterly installments should be eliminated (if that tax is retained). Elimination of this payment option would increase compliance with the highway excise taxes while eliminating the need for tracking relatively small amounts of tax due from numerous taxpayers.

The Joint Committee staff recommends that several technical modifications should be made to the present Code provisions governing motor fuels refund procedures and tax collection: (1) timing and threshold requirements for claiming quarterly refunds should be consolidated to allow a single claim to be filed on an aggregate basis for all fuels; (2) to the extent necessary to implement item (1), differing present-law exemptions should be conformed; (3) clarification of the party exclusively entitled to a refund should be provided in cases in which present law is unclear; (4) the regulatory definition of "position holder" (the party liable for payment of the gasoline, diesel fuel, and kerosene taxes) should be modified to recognize certain two-party terminal exchange agreements between registered parties; and (5) the condition of registration requiring terminals to offer for sale both undyed and dyed diesel fuel and kerosene should be eliminated. Consolidation and clarification of differing rules that affect similar transactions by taxpayers would provide certainty to taxpayers, as well as reducing needed IRS resources in administering these taxes.

Airport and Airway Trust Fund excise taxes

The Joint Committee staff recommends that liability for the commercial air transportation taxes should be imposed exclusively on transportation providers.

The Joint Committee staff recommends that the penalties for failure to disclose commercial air passenger tax on tickets and in advertising should be eliminated. Department of Transportation consumer protection disclosure requirements would remain in force for these as well as other currently regulated fees and charges.

The Joint Committee staff recommends that a uniform, statutory definition of the tax base for the commercial air freight tax should be enacted with any exclusion for accessorial ground services being specifically defined. This recommendation would provide a level playing field for all air freight carriers, and also would eliminate numerous audit disputes that occur under present law.

The Joint Committee staff recommends that the current definition of commercial air transportation, as applied to non-scheduled transportation, should be reviewed and, if appropriate, conformed to Federal Aviation Administration aircraft safety and pilot licensing regulations.

The Joint Committee staff recommends that the present-law Code provisions governing aviation fuel refund and tax collection procedures should be coordinated with comparable rules for Highway Trust Fund excise taxes, if possible.

Harbor Maintenance Trust Fund excise tax and tax on passenger transportation by water

The Joint Committee staff recommends that the Harbor Maintenance Trust Fund excise tax and the General Fund tax on passenger transportation by water should be eliminated. This recommendation would conform the Code to court decisions and U.S. international trade obligations.

Aquatic Resources Trust Fund excise taxes

The Joint Committee staff recommends that the sport fishing equipment excise tax should be eliminated. The current tax requires excessive factual determinations and disadvantages some industry participants relative to manufacturers of similar, untaxed articles that compete in the marketplace.

Federal Aid to Wildlife Fund and non-regular firearms excise taxes

The Joint Committee staff recommends that Federal Aid to Wildlife Fund and non-regular firearms excises taxes should be eliminated. If the taxes are retained, consideration should be given to (1) consolidating certain of the taxes and (2) changing the tax rates to fixed-amount-per-unit rates in lieu of the present ad valorem rate structure to reduce factual and tax-base issues arising under the current structure. Tax law simplification would be furthered if the dedicated taxes were repealed and the Wildlife Fund program financed with general revenue appropriations.

Black Lung Trust Fund excise tax

The Joint Committee staff recommends that the Code provisions on exported coal should be modified to eliminate the provisions imposing tax on coal mined for export in light of a recent court decision holding that portion of the tax to be unconstitutional.

Communications excise tax

The Joint Committee staff recommends that the present-law Federal communications excise tax should be eliminated. If the tax is not eliminated, the Joint Committee staff recommends that: (1) liability for the tax should be shifted to telecommunications service providers so that unpaid tax would be collected as part of regular bad debt collections; (2) the present Code provisions should be updated to reflect current technology; and (3) broad grants of regulatory authority should be provided to the Treasury to allow it continually to update the tax base to reflect future technological changes. Under present law, the communications tax does not reflect the state of technology in the industry, thereby giving rise to disparate treatment of different providers of similar services and requiring highly factual determinations as to when services are taxed.

Ozone-depleting chemicals excise tax

The Joint Committee staff recommends that the ozone-depleting chemicals excise tax should be eliminated as deadwood in light of provisions of the Montreal Protocol and the Clean Air Act that significantly restrict the use of the chemicals subject to tax.

Alcohol excise taxes

The Joint Committee staff recommends that the three separate excise taxes currently imposed on alcoholic beverages should be consolidated into a single tax, with the rate being based on alcohol content of the beverage. The Code provisions governing operation of alcohol production and distribution facilities similarly should be consolidated to the extent consistent with overall operation of Federal alcohol regulation laws.

The Joint Committee staff recommends that, if the current three-tax structure is retained, the reduced rates for production from certain small facilities and for distilled spirits beverages containing alcohol derived from fruit should be eliminated. This recommendation would result in identical beverages being subject to the same tax rate, thereby eliminating economic advantages that currently flow to some, but not all, producers of the same product as well as reducing recordkeeping requirements on taxpayers.

The Joint Committee staff recommends that the alcohol occupational taxes should be eliminated. These taxes are in the nature of business license fees and serve no tax policy purpose.

The Joint Committee staff recommends that the rules governing cover over of rum excise taxes to Puerto Rico and the U.S. Virgin Islands should be consolidated to reduce Federal administrative resources required for this revenue-sharing program.

Tobacco excise taxes

The Joint Committee staff recommends that the present excise taxes on pipe tobacco, roll-your-own tobacco, and cigarette papers and tubes should be consolidated into a single tax on pipe and roll-your-own tobacco.

The Joint Committee staff recommends that the tax rate imposed on cigars should be modified to eliminate the *ad valorem* component. Adoption of this recommendation would reduce audit issues as to the correct tax base in transactions where the products are sold between manufacturers and related parties in the distribution system.

The Joint Committee staff recommends that the tobacco occupational tax should be eliminated. This tax is in the nature of a business license fee and serves no tax policy purpose.

14. Tax-exempt bonds

Unrelated and disproportionate use limit

The Joint Committee staff recommends that the unrelated and disproportionate use limit under which no more than five percent of governmental bond proceeds may be used for a private purpose that is unrelated to the governmental activity also being financed should be eliminated. The general limits on private business use of governmental bond proceeds, combined with the requirement that certain larger issues receive an allocation of State private activity bond volume authority, adequately restrict issuance of tax-exempt governmental bonds to situations in which a private party does not receive excessive benefit.

Prohibition on use of private activity bond proceeds for certain business

The Joint Committee staff recommends that the prohibition on using private activity bond proceeds for certain business should be conformed for all such bonds and consolidated into one Code section. The multiple sets of rules for similar types of bonds create unnecessary complexity for taxpayers and the IRS.

Obsolete and near-obsolete provisions

The Joint Committee staff recommends that the special qualified mortgage bond rules for residences located in Federal disaster areas, which have expired, should be eliminated as deadwood.

The Joint Committee staff recommends that the temporary gubernatorial authority to allocate the private activity bond volume limits, which has expired, should be eliminated as deadwood.

The current qualified mortgage bond and qualified veterans' mortgage bond programs substantially overlap. The Joint Committee staff recommends that only one mortgage interest subsidy—qualified mortgage bonds—should be provided through the issuance of tax-exempt private activity bonds. Consolidation of two similar provisions would reduce the need for duplicate administrative agencies and eliminate potential confusion among potentially qualifying beneficiaries and among potential lenders in those States that issue both qualified mortgage bonds and qualified veterans' mortgage bonds.

The Joint Committee staff recommends that the $150 million limit for qualified section 501(c)(3) bonds should be eliminated as it relates to capital expenditures incurred before the date of enactment of the Taxpayer Relief Act of 1997. This limit was repealed in 1997 for capital expenditures incurred after enactment of the Taxpayer Relief Act.

The Joint Committee staff recommends that the qualified small-issuer exception for certain bank-qualified bonds should be eliminated in light of the development since 1986 (when the rule was enacted) of State bond banks and revolving pools that provide needed market access for smaller governmental units without the bank subsidy provided by the exception. In addition, provisions of the Community Reinvestment Act now require banks to invest in local projects without regard to subsidies such as that provided by this exception. The elimination of this exception would help streamline the arbitrage rebate rules without disadvantaging qualified small-issuers.

Public notice requirement

The Joint Committee staff recommends that the "public notice" requirement for a qualified private activity bond should be allowed to be satisfied by other media if the objective of reasonable coverage of the population can be met. For example, notice via the Internet in addition to radio and television would satisfy an expanded public notice requirement. The Joint Committee staff recommends that, in lieu of a public hearing, the public comment requirement should be satisfied by written response and Internet correspondence. The recommendation would reduce the compliance burden by offering issuers less costly ways to obtain public scrutiny of proposed bond issues.

Arbitrage rebate

The Joint Committee staff recommends that the present-law construction period spend down exception should be expanded to 36 months with prescribed intermediate targets. Expanding the present-law construction period spend down exception to somewhat longer construction projects would expand the number of issuers who are not required to track temporary investments and compute arbitrage without creating excessive incentives to issue bonds in larger amounts or earlier than needed for governmental purposes in order to invest proceeds for profit.

The Joint Committee staff recommends an increase to the basic amount of governmental bonds that small governmental units may issue without being subject to the arbitrage rebate requirement from $5 million to $10 million. Specifically, these governmental units would be allowed to issue up to $15 million of governmental bonds in a calendar year provided that at least $5 million of the bonds are used to finance public schools. This recommendation reflects the increased dollar costs of activities financed by smaller governments since the provision was enacted in 1986 without expanding the benefit beyond those smaller governments that often lack in-house accounting staff to perform needed investment tracking and arbitrage calculations.

15. Estate and gift tax

The Joint Committee staff recommends that the qualification and recapture rules contained in the special-use valuation and the qualified family owned business provisions be conformed to the extent practicable. Uniform rules to the extent practicable would make these related estate tax benefits easier to understand and administer.

16. Deadwood provisions

The Joint Committee staff recommends that out of date and obsolete provisions in the Code should be eliminated. The Joint Committee staff has identified more than 100 provisions that could be eliminated as deadwood.

Chairman HOUGHTON. Thanks very much, Mrs. Paull. I just have a quick question, and I will pass it over to Mr. McCrery and others. It has always amazed me that we don't get at this every year, I mean every year, and for us to start a series of tax simplification proceedings—and I know other people have gotten out of it and a lot of things have been written about it, but many times I will talk to the Treasury and they will say this is a really a government policy issue; or I will talk to the IRS and they will say, really it is not ours, it is the Treasury Department's.

So we just keep going around in circles. And I think that you can help us not only in prioritizing, which you have, in terms of obsolete provisions and uniform definitions and things like that, but also help us to set us on a course where we can help those people who must help all the citizens out there, because this is really ridiculous. There is just so much wasted time, so much wasted effort, so many things burned up in the process.

So the only thing I plead with you is, as we go along here and have these other hearings, help us think through, prioritize, but also find handles that we can get on with this.

Mr. McCrery.

Mrs. PAULL. Mr. Houghton, if I could just respond very briefly. I think a red flag should come up with the Committee Members when the provision is of a very narrow scope and it doesn't have a broad application, because when you load up the Tax Code with these very, very narrow provisions, you start seeing difficulties in applying and understanding the tax law.

Chairman HOUGHTON. And also I think your point about the cost and benefit of some of these things, we very rarely talk about that. It is a side issue; it is not a core issue. Thank you very much.

Mrs. PAULL. You are welcome.

Chairman HOUGHTON. Mr. McCrery.

Chairman MCCRERY. Just one topic I would like for you to touch on, and that is the AMT, alternative minimum tax. If I am not mistaken, in your report you recommend total repeal of alternative minimum tax for individuals and corporations; is that correct?

Mrs. PAULL. That is correct, Mr. McCrery.

Chairman MCCRERY. I have often heard, and I will see if you agree, that the easiest thing we could do to simplify the Tax Code in one fell swoop would be to repeal the alternative minimum tax. Is that one of the—one of the main things you would recommend for simplification is repeal of the AMT?

Mrs. PAULL. Yes, it is. Our report starts with the repeal of the AMT. While we didn't necessarily order our recommendations, the fact that the report starts with the AMT indicates we thought it was a pressing issue. For those people who might be subjected to the alternative minimum tax or are in fact having to make those calculations, they are having to make a completely double set of calculations to figure their income taxes. It is not bad enough to have to do it once, but they get to do it twice. Many people must run through a check box of questions as to whether or not you should try to make those computations. Many people make them when they are actually not going to pay the tax. Unfortunately, in the future, many people are in fact going to be minimum taxpayers. They would have been under the previous law before the large bill that was just signed into law, and even more will be minimum taxpayers.

The profile of the individuals that we are dealing with here tend to be large families or in a high income tax State, or they may have some other things like incentive stock options that will throw them in in 1 year. Sometimes you are in, sometimes you are not, but over time we are going to see a lot more people who are consistently in the AMT. It is a very complicated system, and it was not designed for those types of people.

For businesses, some of them have to compute their taxes three ways. It is really kind of mind-boggling, the paperwork that they have to go through to comply with the alternative minimum tax. Again, they may go back and forth from year to year. Many of the reasons why there was an alternative minimum tax no longer are present. The regular tax has been changed, the alternative minimum tax was not, and so it is just picking up aberrational cases, and more than was ever intended.

Chairman MCCRERY. Well, for purposes of today's hearing, it is not so much the actual alternative minimum tax that some taxpayers have to pay—and you say that number is going to grow—it is the complexity that it adds to the Code and to the calculation of one's taxes. And in fact, Mrs. Paull, isn't it correct that every taxpayer that itemizes his deductions has to go through the minimum tax calculation?

Mrs. PAULL. Yes they do to make sure that they are not going to be a minimum tax payer. If you knew something—if you were a lower income person and you knew something about the minimum tax, you might be able to do it shorthand, but most people have to go through various calculations to figure out whether or not they are AMT taxpayers.

Chairman MCCRERY. Thank you.

Chairman HOUGHTON. Thanks very much, Mr. McCrery. Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman.

Mrs. Paull, based on your analysis of the Tax Code and the study you did and the recommendations you made, who bears more of the responsibility for the complexity of the Code; the tax-writing committees of Congress or the IRS?

Mrs. PAULL. Well, we did not try to identify it in that way. We have a long list of contributing factors.

Mr. COYNE. You have done an exhaustive study of the Code, and I am just asking for your professional opinion. Who bears more of the responsibility?

Mrs. PAULL. I would say that obviously the Congress bears a significant responsibility because they write the tax laws.

Mr. COYNE. Thank you. What policy considerations prevented you from making comprehensive recommendations in the areas of dependency exemption, child credit, earned income tax credit?

Mrs. PAULL. We made some recommendations in that area that we think are long overdue, having to do with the unified definition of a child for the five purposes of the Tax Code. It is possible to go further structurally to make additional simplifications of some of these provisions, but we believe the recommendations we made are significant. This was our first report, the first time we had done a comprehensive report like this, and we were not given very much guidance by the Congress on what kind of recommendations to make. So we made the recommendations that we felt were appropriate, which were not to second-guess policy decisions, but to try to go about implementing the policy of the Congress in a simpler way. You could give us some authority to look at specific areas to make recommendations, and we could give you some options with respect to the policy trade-offs that you could make. But we were really trying to focus on simplifying and implementing in a simpler way existing policy decisions in the Tax Code.

Mr. COYNE. But aren't some of the areas that I cited, like dependency exemption, child credit, earned income tax credit—aren't these exactly the ones that cause taxpayers most of the trouble?

Mrs. PAULL. One of the big reasons they have a lot of trouble is because they might have a child that qualifies them for one provision, and then they think they are qualified for all the other purposes and they are not. So, again, we made a recommendation for a unified definition of child so that when you qualify for one provision, you qualify for them all. In some instances, our recommendation would expand some of those provisions from present law if you were to move forward with that, but generally it would make it so much simpler for millions of people with children under the age 19 or 18.

Mr. COYNE. But they do tend to be the areas that cause the most trouble for taxpayers; is that correct?

Mrs. PAULL. That is a significant area, yes.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. McNulty.

Mr. MCNULTY. Thank you, Mr. Chairman. I yield to Mr. Neal.

Mr. NEAL. Thank you Mr. Chairman. Thank you, Mr. McNulty.

First of all, Mrs. Paull, let me thank you for last year for accepting many of my recommendations——

Mrs. PAULL. You are welcome.

Mr. NEAL. In H.R. 1420, and certainly you demonstrated wise judgment in that instance. What do we do to ensure that this tax simplification study really becomes real tax simplification for the American people as opposed to just another study?

Mrs. PAULL. Well, you know, we took our job seriously. We did not view this as a study that would be put on the shelf, that would be collecting dust. Simplification is an ongoing process. Our report is an outgrowth of a major initiated by this Committee on the IRS Restructuring Act, and we took it seriously. Now we hope the Congress will take our report seriously and act on some of the recommendations and develop additional ones.

Mr. NEAL. What is the disincentive for Congress not to take it up?

Mrs. PAULL. The disincentive? Well——

Mr. NEAL. I heard the former Chairman of this Committee for 6 years talking about yanking the Tax Code out by its roots and throwing it to the side. We are no closer to that today than we were the day that he first said it. That was a big thing around here 6 years ago. We were going to tear the Tax Code apart and we are going to have a simplified Tax Code, and we are going to have a flat tax and we are going to have all these other things. President Bush put it on the front page of the New York Times yesterday; so we are all worked up about it again. It has been circulating in this arena for a long time, and we haven't done anything about it.

Mrs. PAULL. Mr. Neal, we didn't approach this, as our report deals with fundamental tax reform. Again, we approached it as is exploring if there is a simpler way to implement the policies of the present tax law, and we felt that was our mission. Obviously, the Committee can consider fundamental tax reform. My experience has been that there isn't a consensus on fundamental tax reform as to which way to go. That is a political issue and a policy issue for the Congress, and it appears to be stymied. Then you still have the Tax Code and there are still many, many well-intended ideas going into the Tax Code. This is an opportunity for you to step back and take a broad look and see if there isn't something you can do to make life simpler for a lot of people.

Mr. NEAL. Did you say well-intended or well-intentioned?

Mrs. PAULL. Both.

Mr. NEAL. Good follow-up. Bear with me for a second. I want to raise a point with you, and you really have tried hard to answer these questions in the past, but give me a few minutes here.

You are certainly familiar with the incentive stock option alternative minimum tax problem. This, as you know, is a poster child for the unintended consequences of the complexity in the Code. On the one hand, we have a regular Tax Code telling people to keep their exercise incentive stock options for a year to get long-term capital gains; then we tax them immediately in AMT. And since thousands of people were unaware of this interaction, now people are paying all or part of their tax bill by cashing out of their pensions, taking second mortgages, and contemplating filing for bankruptcy. Now, let me just read you part of a letter that I received:

“Dear, Mr. Neal, my husband’s company, quote, rewarded him with an incentive stock option for his hard work and dedication to the company. Since we exercised incentive stock options when the price was about triple the current value of the stock, we were forced to pay over $150,000 in AMT taxes, which is approximately the current value of the stock if we sold it today. If we sold the stock to pay the taxes, our real tax rate would be close to 100 percent, not the 25 percent the AMT is supposed to be. We are lucky enough to be able to take out a second mortgage on our home; however, several of our friends have not been so lucky. In this instance people conceivably could be losing their homes, vehicles, and child education funds because of the AMT and the timing of the tax at the exercise of International Organization for Standardizations (ISO).”

Is this a result of the kind of complexity in the Tax Code that we should be worried about, Mrs. Paull?

Mrs. PAULL. Yes it is. I think the incentive stock option is not the only issue that people face. I certainly heard some very unfortunate situations dealing with actual capital gains that were realized, reinvested in the stock market, and the market fell and they had to pay their tax on their capital gains for last year. But that is not to say this is an unfortunate circumstance that should be addressed at the appropriate time.

Mr. NEAL. Well, let me ask you this. Have we ever backdated pro-taxpayer changes in the Tax Code because of policy reasons or because of an injustice?

Mrs. PAULL. Well, I think the fundamental policy question for this Committee is the AMT serving the purpose for which it was designed? You are giving an example of someone for whom the AMT was not designed to cause them to pay a hardship tax on them. I don’t think the AMT was designed for large families to have to pay the AMT, or people living in high-tax States, or the kinds of profiles of people that you are seeing now having to pay the AMT. This is the crux of the fundamental policy of the question. We certainly considered whether or not the AMT ought to be fixed, so to speak, rather than recommend repeal. But we couldn’t see an obvious big fix to it that was appropriate, and so we made a recommendation of repeal both on the individual and on the business side.

Mr. NEAL. What was the cost, do you recall?

Mrs. PAULL. The cost was at the time we made the recommendation, about 200 billion over 10 years on the individual side. I don’t know what it was on the business side. But that cost has gone up significantly since the recent tax bill, and I don’t have a precise figure for you today. I know you have an estimate request in for it and we are working on it.

Mr. NEAL. Thank you very much. Finally, Mrs. Paull, I pursued this issue with some diligence, as you know——

Mrs. PAULL. Sure.

Mr. NEAL. For a considerable period of time. It seems to me that the AMT issue not only highlights the complexities that we are talking about, but it really is something that we could have done before we took up tax issues. There was room to get this done, and the Chairman has acknowledged that we have to get it done. And just to point out to the members of the two respective Subcommittees that are here today, the longer the problem goes on, not only the more complicated it becomes but the worse it gets. So it is going to be more costly to fix next year than it was this year. You are free to comment on that if you would like that.

Mrs. PAULL. That is true.

Mr. NEAL. Thank you. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thanks very much. Mr. Ryan.

Mr. RYAN. Thanks, Mrs. Paull. This is my first time up here, actually, in this top tier. Nice to be here. I want to ask you one question about your capital gains recommendation and then two questions about policy decisions. I know you were restricted to the parameters of not making recommendations that would change underlying policy; but first could you describe to me your recommendation on your capital gains provision which would be a flat tax rate on a deduction from capital gains net calculation? Is that how you would do it?

Mrs. PAULL. Yes. Our recommendation on capital gains would be to go back to the way it was before the Tax Reform Act 1986——

Mr. RYAN. Pre-TRA.

Mrs. PAULL. Which would be to have a flat exclusion or deduction for whatever percentage the Congress chooses—it had been various percentages over the years before the change in the law. This new notion of putting a cap, or a maximum rate, on capital gains has added tremendous complexity, and now we have even more people who are investing in the stock market. We have over 27 million people who are filing an incredibly complicated Schedule D now. So that is another proposal, honestly, that would have widespread applicability that should be attended to soon.

Mr. RYAN. And depending on where you set the level, I suppose, would you include an indexing component of that? Because if you set the level too low, it is going to be a big revenue raiser. I assume you would probably calculate that. Where would you estimate the revenue neutral to be set at; not the rate but the level?

Mrs. PAULL. We had estimated it in the past in the high 30's percent; but after this new tax bill we have to reestimate it, and we have not done that yet.

Mr. RYAN. In your model right now——

Mrs. PAULL. But indexing, I would just note, is a separate matter. One of the issues with indexing in the past has been the complexity it would add to the Tax Code.

Mr. RYAN. And I think you and I have talked about this once before, but do you believe that the revenue-maximizing rate for capital gains right now is something like 22 percent? Is that what your model projects?

Mrs. PAULL. Because we have had such a substantial tax cut this year, we would have to go back review the rate and get back to you on that. I would be happy to do that. It will have a different effect under lower tax rates.

Mr. RYAN. Right. Right. Going on to—I think in your testimony in the beginning you talk about being restricted to the parameters of things that would not make policy changes. You talk about changing depreciation, quote, determining whether an expenditure is a capital expenditure that cannot be currently expensed, and modifying the rules relating to the depreciation of capital assets. Obviously, that is a real source of an incredible amount of complexity in the Code.

Could you expound on any ways that could make that simpler, including possible policy changes?

Mrs. PAULL. Well, we would be happy to work with you on that. I think the notion would be to try to determine a broader category of types of assets that could be currently expensed, and perhaps have a smaller number of categories of depreciable lives, so you could lump more equipment together. But when you do that, you are going to have winners and losers. Some averaging would go on, but you certainly could simplify the depreciation regimes, on a revenue-neutral basis or some other basis.

Mr. RYAN. On a revenue-neutral basis, do you believe that neutral cost recovery—you know, the concept of bringing forward the time value of money with respect to depreciation—can be done in a revenue-neutral way, which also makes depreciation more or less complex?

Mrs. PAULL. Well, again, I haven't looked at that proposal in years, but it had an indexing component to it. And when you have an indexing component to these kinds of proposals, you are going to end up with a much more complicated system than you start out with without the indexing. When you take into account the time value of money, you end up accelerating deductions. And so you end up having to overcome the revenue loss from that.

Mr. RYAN. I think the last time your Committee scored that, though, that was—that was a revenue-neutral provision; correct?

Mrs. PAULL. I am not sure. It has been a long time since I have looked at that estimate.

Mr. RYAN. Has anybody taken a look at that?

Mrs. PAULL. I think the last time we had looked at it was in early 1995, and the cost was significantly higher than the Committee wanted to get into at the time.

Mr. RYAN. Did that have indexing at the time——

Mrs. PAULL. I don't know the number off the top of my head.

Mr. RYAN. One more quick question. I know that this is not in the report either, but have you given thought to studying the multiple levels of taxation that occurs in any given dollar moving through the economy? Have you looked at analyzing the different layers of taxation that occurs moving from individual to business and back and forth through the economy, and calculated the cost of its complexity or tried to nail down exactly how that effect occurs through the Tax Code?

Mrs. PAULL. Mr. Ryan, we have not. We are much more focused on the individual provisions of the Tax Code at this point. We have never done a study like that.

Mr. RYAN. Or not even on the individual side?

Mrs. PAULL. Not that I am aware of.

Mr. RYAN. OK. I see my time is up. No further questions.

Chairman HOUGHTON. Fine. Thanks very much, Mrs. Paull. Mrs. Thurman.

Mrs. THURMAN. Thank you, Mr. Chairman.

Mrs. Paull, first of all, let me compliment both you and your staff for trying to put this together. I can't even imagine what kind of an undertaking this had to have been to go through all of these issues. And I was particularly moved by page 109 in Volume I where you actually talk about the effects of complexity on perceived fairness of the Federal tax system. But, more importantly, at the end, where it says "cynicism among taxpayers which ultimately can lead to intentional noncompliance" is a pretty interesting statement, when particularly this Committee writes the bills and, in fact, either give or take from the taxpayer, and fairness obviously is a big issue for them.

So in saying that, let me ask you this. In the last markup that we had in this Committee, there was quite a bit of debate on the charitable givings as to the complexity that might be incurred by the taxpayer for this particular piece of legislation. And I think it was pointed out once or twice that it really was about $3.56 when you got done with it all, for the complexity. I remember when the Committee talked about the simplification and the analysis particularly.

In any of these volumes, is there any recommendation in here at all that, since we have already acknowledged that Congress is the tax-writing body, that we should in fact put the analysis and simplification before, as part of the analysis of the tax bills before us, as versus waiting to the end, when we get it at the end of the report, after we have had the markup and before we go to the floor, in the fact that, quite frankly, what I have seen around here, once we get to the floor, very little action is taken based on what the analysis was given us?

So is there any kind of a recommendation in here that suggests that we should actually use the simplification analysis as a part of the taxwriting process?

Mrs. PAULL. We were trying to make recommendations with respect to the actual structure of the tax law in this report. We obviously are the ones who shepherd the complexity analysis. The way the process is working on tax legislation, there is not adequate time for full consideration to be given to this. The standard that we have been using in order to determine whether or not to prepare a complexity analysis is a standard that you have to have—and this is what the statute says, too—widespread applicability. And we are using a standard of at least 10 percent of individual taxpayers or small businesses being affected. The non-itemizer deduction, of course, did meet that standard, but there is an awful lot of provisions that do not meet that standard, but add complexity to the Tax Code.

We don't have the resources to keep on top of every single proposal, to be honest with you. So we are doing the best we can. It is a new role for us since the 1998 act, and I think that it does provide some useful information. It is mostly far along in the process; because, as you said, while I am prepared at the markup to discuss it, you don't get anything in writing until the report is filed. And at that time, we have asked the Treasury Department and the IRS to scramble and give us something for the report so it is available for floor action.

Mrs. THURMAN. Why would——

Mrs. PAULL. And then the legislation moves over into the Senate, and the Senate is, of course, adding many more provisions, and the same thing is going on. So it doesn't lend itself, considering the way the tax laws are written right now, to be part of the mix very easily, because the laws are written in such a time compressed way.

Mrs. THURMAN. But the idea of the law specifically was to in fact make sure that Congress was aware of the complexities as we wrote——

Mrs. PAULL. Right.

Mrs. THURMAN. The laws. I mean, that was the idea.

Mrs. PAULL. Right.

Mrs. THURMAN. I mean, we talked about how the IRS should be involved in this because, quite frankly, that is as much of a problem as anything because when we send it out there into, you know, kind of the IRS divisions, each one of these divisions is interpreting the law a little bit differently; so therefore some of our taxpayers are feeling like they are not getting the fair representation of the Tax Code, and I would still go back to page 109.

I think, and I would say to the Chairman, Mr. Chairman, I hope that as we go through this, that what we do up here should not be done in such a rush that we can't look at this complexity, because then all of the things that we are doing today mean nothing to us in the future. Thank you.

Chairman HOUGHTON. Is that it, Mrs. Thurman? OK. Good. Let me understand your time. You have got to get out of here pretty soon, don't you? Have you got enough time to continue the questions?

Mrs. PAULL. I can continue taking questions.

Chairman HOUGHTON. OK, fine. Ms. Dunn.

Ms. DUNN. Thank you, Mr. Chairman. I think this is a fascinating report, and I appreciate our having it so that we can look through it. And I am wondering, Mrs. Paull—I will wait until you finish.

Mrs. PAULL. Sorry.

Ms. DUNN. You talked about 55 percent of tax returns currently being done by professionals. I am not sure whether that increase that you stated is due to the complexity of the Code or the continuing lack of time in a normal person's life these days. But I wonder, just off the top—and briefly—if you think that the numbers of professionals who are preparing tax returns are going to increase until we have a complete reform of the Tax Code.

Mrs. PAULL. Well, there is an increase both in the paid professionals as well as in the use of computer software, where you can go out and buy a computer program to help you with your tax return. We are not sure why, but there is a growing use of both by non-itemizers. I think you can only assume that, even though they have a very simple tax return, they are very intimidated by the instructions and whether or not they can get it right. As a result, more non-itemizers have to use someone else or to buy software because they are not confident they can get it right.

Ms. DUNN. They just don't want to face one more problem in their lives.

Mrs. PAULL. They don't want that letter from the IRS, I think.

Ms. DUNN. And they want to do it right and they want to do it fairly and they want to stay out of trouble.

Let me ask you a question. Something that has concerned me recently in some of the moves that we have done as we work toward making the Tax Code fairer and less of a burden on the backs of normal taxpayers, and that is the increasing gap between corporate capital gains and individual capital gains. It seems to me that at some point we have to figure we are really voting in favor of the individual and against the corporation in how we are collecting these taxes. And I am wondering if it is not going to lead to a reorganization in some businesses in order—as REITs, Real Estate Investment Trusts, for example, in order to avoid paying the high capital gains that corporations have to pay. What do you think would be the situation? Would we be better off if we had a lower capital gains rate that applied equally to corporations and individuals?

Mrs. PAULL. Well, we are getting into not so much simplification but a policy call that needs to be made by the Committee. The issue with respect to a lower capital gains rate has been focused on individual investors, because they tend to be very sensitive to the rate at which the capital gains are taxed.

Therefore you find a lot of incentive being derived from a lower capital gains rate. With respect to corporations, the economic literature is not very supportive of a lower rate in the sense of providing an incentive because businesses are going to invest for solid business reasons and for the long haul. So the incentive part of it has been always a little bit cloudy, and that is why I think the law has developed the way it is.

On the other hand, there are certain industries, and I think you know I am familiar with an industry that has a presence in the Northwest, that a lower corporate capital gains rate could make a big difference.

Ms. DUNN. That of course is the timber industry. I appreciate your mentioning that.

Let me ask you a question. You mentioned in your testimony a recommendation for simplifying the qualifying rules for children and I am wondering if you could describe how that works, why that is a problem right now, and also perhaps at the same time why is it difficult to account for the income of minor children?

Mrs. PAULL. Let me start with the definition of qualifying children. As we discussed in our report, in order to figure out whether or not a child qualifies you for the earned income credit, the dependent care credit, the dependency exemption, head of household status, and the $500 now increasing to $1,000 child credit, you have to go through a maze. And it is literally a maze, 17 pages of instructions, all kinds of flow charts. We did an outline in our report comparing the different eligibility criteria, and it is 7 pages long and it is an outline. So it is very difficult to try to figure out if your child qualifies you for each of these things or which one you are eligible for.

And as I said, it is extremely confusing. You make it through the maze for one provision and you think you are home free on all of them. So that particular recommendation is, I would hope, at the top of the list of things that Members would be interested in pursuing. With respect to children under the age of 14, right now we have a very complicated system, called the kiddie tax, to try and determine the tax on the unearned income of those children. This provision was well-intentioned but it is extremely complicated to try to figure out how much tax your child under the age of 14 should pay. So we have a recommendation in our report to make it much simpler.

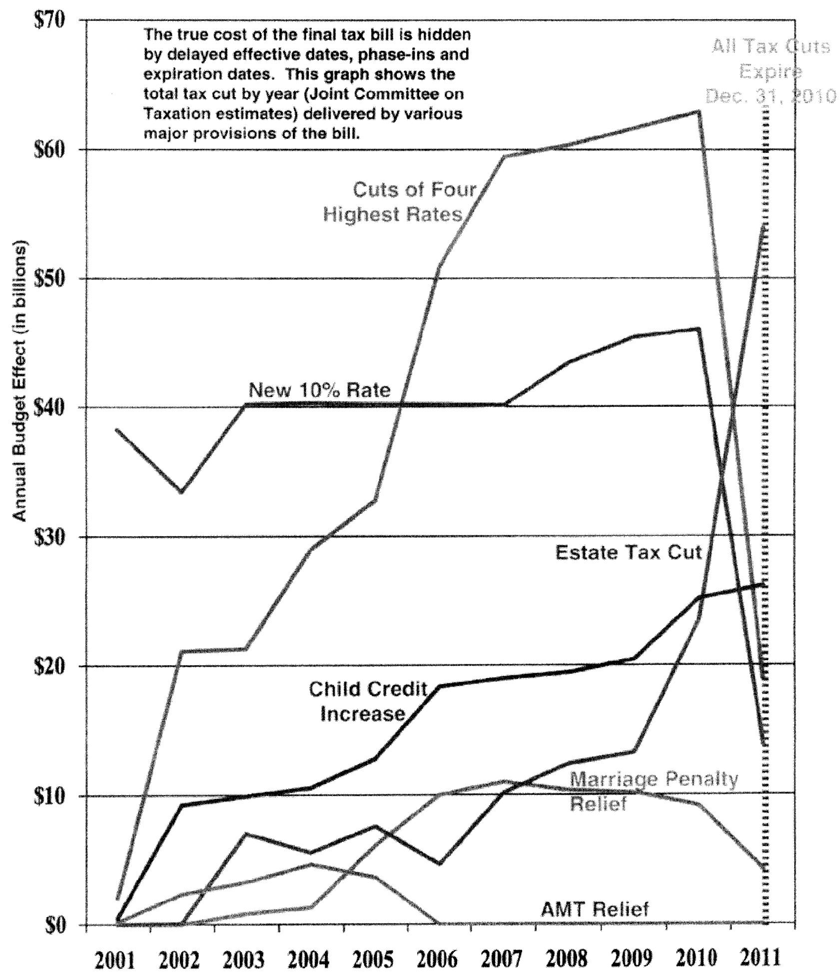
Ms. DUNN. Mr. Chairman, I do hope we can put those at the top of our list. I think it would save a lot of families a lot of time.

Chairman HOUGHTON. Well noted. Thanks very much. Mr. Pomeroy.

Mr. POMEROY. Hello, Mrs. Paull. You know I am new on this Committee and, honestly, it just drives me nuts that it seems like we can't hold two thoughts in our head at the same time. And so when this Committee was considering tax cuts, we talked about all manner of tax cuts but we didn't talk at all about tax cuts relative to simplification and Code complexity. That is like an entirely different thought that we hold at other periods of time.

I would like to show you a chart. We have tried to diagram, and it is complex to do, but we have tried to chart the phase-ins and the phase-outs of the various aspects of the recently enacted Tax Relief Act. And as you can see, some are calling it the hokey-pokey tax cut. You phase a tax cut in, you phase a tax cut out, you phase a tax cut in, you shake it all about. I just would ask you straight up, when the Tax Relief Act is completely implemented, assuming no change, will the Code be more complex than today or less complex?

The Tax Bill Giveth and the Tax Bill Taketh Away



Prepared by the Democratic Staff of the Committee on Ways and Means, Charles B. Rangel, Ranking Member May 29, 2001

Mrs. PAULL. It will be more complex. We indicated that in our testimony.

Mr. POMEROY. One feature where you have made, I think, an important recommendation relates to elimination of the alternative minimum tax. Now check that. Before I get to the AMT, I don't really understand the constraints of the Joint Tax Committee. I mean, you answered questions for some hours before this Committee as we considered the tax cut, and during the pendency of the report that came out this April I never heard you discuss simplification. Were you precluded from doing it under the direction of the Committee or how come simplification never came up?

Mrs. PAULL. Mr. Pomeroy, I am here to explain to the Committee the provisions and answer questions. Now there were a lot of questions, if I remember right, about the alternative minimum tax, the implications of that tax, of the lowering of the regular income tax rates, throwing more people on the AMT. It is going to make the system more complicated for a lot of people. Many of the provisions that were before the Committee were not phased in and sunsetted the way the final bill ended up. So that discussion really didn't occur before the Committee because the provision wasn't before the Committee.

But, last week when we were talking about the non-itemize or charitable deduction, I think we had a very good discussion about complexity. I am here to help you out in any way I can.

Mr. POMEROY. I wish this idea that you all advanced in your April report about elimination of the AMT had taken root with the Committee, and we really wrestled with it as we evaluated what to put into the package. I think we could have had a package that in the end wouldn't have looked like that; it wouldn't have required future work.

Mrs. PAULL. Unfortunately, I think you marked up the rates in March, our report came out in April after 18 months of work. We were working as hard as we could in between the Congress' legislative activity. I didn't let our staff have Easter break because of this report.

Mr. POMEROY. But 1 month later on Memorial Day we enacted a significantly more complicating component to the Tax Code. So it is unfortunate sometime during the month of May we did not quite catch from you what you were recommending and what you were recommending be something quite different than what we were doing. What is your relative belief to be able to achieve simplification in a relative neutral way without touching any of those tax cut phase-ins or finding other spending offsets or dipping into trust funds or using the contingency fund, if there is a contingency fund? Can you get the job done on a revenue neutral basis within the Code or does it have a revenue impact?

Mrs. PAULL. Well, some of these proposals you can probably do on a revenue neutral basis, but of course you are going to make some tradeoffs because somebody's tax provision may not be as generous as it is under present law. And in order to achieve a broader simplification——

Mr. POMEROY. Could one conclude that really in order to in a meaningful way advance simplification we will need to revisit some of the aspects of the recently enacted tax legislation?

Mrs. PAULL. I would imagine what seems to be the easy target around here is the high rates.

Mr. POMEROY. Thank you. Thank you, Mrs. Paull. I yield back, Mr. Chairman.

Chairman HOUGHTON. Thank you very much. Mr. Weller.

Mr. WELLER. Thank you, Mr. Chairman. And thank you, both you and Chairman McCrery, for conducting this hearing. I often hear the folks back home in the south suburbs of Chicago, they always complain their taxes are too high but if you listen a little longer they talk about how complicated and how unfair the Tax Code is and of course the need to simplify it. And there is strong interest and support for simplifying the Tax Code, and listening to some of my colleagues and the questions they have, I would note that in the tax cut that we recently passed and the President signed into law we did move toward simplifying some key provisions, particularly in the area of marriage tax penalty, which I always considered to be one of the more glaring results of our complicated Tax Code. We need to do more.

Our friends in the Senate of course wanted to have a smaller tax cut. At the same time there were those who wanted to do more with a smaller tax cut, which forced us to phase in some provisions that we would liked to have started immediately rather than phasing them in over a period of time. You know, when it comes to the complications, and really the marriage tax penalty is an example there of—when we were first researching the marriage tax penalty we noted that that impacting joint filers was the biggest of them all. But in analyzing the Tax Code there were about 62 other marriage tax penalties. And they, like a lot of other complications in the Code, resulted from the income eligibility and income thresholds and the so-called targeting of the tax, various tax provisions and certain groups that were selected by the President, and the Congress' legislation moved through. I was wondering, Mrs. Paull, just from a historical perspective when did the so-called targeting tax provisions and determining who would qualify, be eligible for certain—such as the child tax credit or the student loan interest deduction—when those income thresholds—was that something that started in the seventies, the eighties, the nineties? When did all that begin?

Mrs. PAULL. The $500 per child credit and the student loan deduction were both enacted in 1997.

Mr. WELLER. Was that a common practice in the Tax Code well before the time that I came onto this Committee to create income thresholds determining who was eligible; is that prior——

Mrs. PAULL. It is becoming a more common thing in the recent decade.

Mr. WELLER. What was the primary reason for that? Was it just for selecting who would qualify or was it for scoring reasons because of limited revenue? What was kind of the primary motivation from your experience?

Mrs. PAULL. Sometimes it would be to provide assistance but only to certain people, and therefore they would put some income limits on it. The other reason would be driven by the budget limitations.

Mr. WELLER. You know, my friend Mr. Ryan touched on one issue which I considered a need to modernize the Tax Code, and that is the whole issue of depreciation. I really believe that technology is driving the need to change how we depreciate assets. It doesn't make sense to carry the office computer on the books for 5 years when businesses on average replace their PCs about every 14 months. It should be expensed. And there is a lot of other taxed assets, wireless and communications medical technology, software, computer components and other assets, that we should expense. From your study, as we look at ways to simplify and modernize the Tax Code, what do you consider to be the chief roadblocks to expensing technology and other assets?

Mrs. PAULL. You have selected a group of equipment or property that you would like to revisit, but there are other groups of property that people would like to revisit. Trying to come up with a uniform way to apply a new set of depreciation rules is the challenge, because while I might have sympathy toward the kinds of property you are talking about, before long we are going to have a whole long other list. That is what has happened over the last few years with respect to depreciation. As a result, the Committee had asked the Treasury Department to prepare a comprehensive study on depreciation—this is a very technical area—but only gave the Treasury Department a limited time period to do the study. I believe the Subcommittees are going to be looking at that study.

But I think what the challenge is, not just a couple of pieces of property, but to try to do the whole thing.

Mr. WELLER. Well, just to follow up on that, you know, I think we are all disappointed with that Treasury study. That report really said little other than we should study it some more. I think we are all very disappointed in what they produced. Obviously it is going to require a complicated effort. Could you also just see from an international competitiveness standpoint any thoughts that you have on the whole issue of depreciation as we work to modernize our Tax Code and make it more user friendly, as we look at how we can better compete in the global marketplace, how depreciation can play a role?

Mrs. PAULL. Mr. Weller, we are in the process of taking a look at this area ourselves. As I said, it is a difficult area. We have been soliciting comments. We are doing a study of how other countries treat depreciation and hope to be able to provide the Committee with some useful information on which to move forward on this. But I think again you have got to roll up your sleeves and do it in a comprehensive way.

Mr. WELLER. The information I have seen, particularly the Asians have a much more attractive treatment of assets, particularly in the area of technology, than we do. Would you agree with that?

Mrs. PAULL. I personally have not looked at it, so I would have to get back to you on it. We are, as I said, compiling this information for this Committee at the Chairman's request.

Mr. WELLER. Thank you, Mr. Chairman.

Chairman HOUGHTON. Mr. Brady, do you have a question? Mrs. Paull, thank you so much. We really appreciate your being with us.

Next I would like to call the panel, Mr. David Keating, Senior Counselor, National Taxpayers Union; Mr. Scott Moody, Senior Economist, Tax Foundation; Mr. C. Eugene Steuerle, Senior Fellow of the Urban Institute; and Mr. William Gale, Senior Fellow of the Brookings Institution.

While you are coming toward the desk, I was just reading over the income tax form for 1913. It makes me want to cry.

All right. Now let's go right ahead. Mr. Keating, would you start?

STATEMENT OF DAVID L. KEATING, SENIOR COUNSELOR, NATIONAL TAXPAYERS UNION

Mr. KEATING. Thank you, Mr. Chairman, and Members of the Committee, for holding this hearing on tax complexity and for inviting me to testify. It is kind of like old age, tax complexity; it has been creeping up on us for many years and you may not notice 1 year at a time, but when you look back at how things have changed over the decades it is shocking. Sixty-five years ago the 1040 instructions, as you pointed out, were just two pages long and even when the income tax became a mass tax during World War II they were four pages long. Today taxpayers have 117 pages of instructions, triple the number in 1975 and more than double the number in 1985. This was the year before taxes were simplified.

I also note that today's news report that the IRS has apparently sent out a half a million erroneous notices about the size of the tax refund checks. So if the IRS can't get it right I am not sure we can expect the average taxpayer to either.

Now, if you need help with something more complicated than the basic 1040 instructions, I think this stack right here that you had on exhibit is a perfect example. This is a total of about 13,000 pages of other forms and instructions that some taxpayers need to file or consult when preparing their return. Even the IRS itself is complaining about the burden. The new annual report of the Taxpayer Advocate cites complexity for individuals and businesses as the number one and two most serious problems encountered by taxpayers and the root cause of the top 20.

It is no surprise, I think, that paid professionals now prepare most of the tax returns. In fact, the use of paid professionals has soared by 50 percent since 1980, and this is even more remarkable when you consider that the average home didn't have access to a computer in 1980. When you look at the tax returns prepared not only by paid professionals but by incredibly sophisticated tax return software, now 80 percent of the people are preparing returns either with computers or paid preparers.

Despite the use of more powerful computers and faster printers, tax preparation fees are on the rise, even when you adjust for inflation. That is solely due to the rising complexity. One way of tracking this trend is to look at the average fee charged by H&R Block, which fortunately is a publicly traded company and has to report how much it makes. In fact, last month the company again raised its dividend and declared a two for one stock split.

You can almost track the growth of the H&R Block stock to the increasing complexity. The average fee they charge is now up to $112 this year, which is a rise of about 50 percent after accounting for inflation. If you don't account for inflation, the increase tops 140 percent.

Now, it has been pointed out by Lindy Paull earlier, that the recent tax law changes have made things more complicated and I suspect things will get worse before they get better. But here is one interesting thing that I found while researching this area for the Subcommittees. I was looking at the Paperwork Reduction Act 1995, which set annual goals for reduction of the paperwork. But this law by any measurement has been an abject failure, largely due to the increasing paperwork burdens generated at the IRS. Now in all fairness to the IRS, these burdens aren't the result of IRS bureaucrats mindlessly dreaming up new forms and regulations. Much of the burden increase has been due to the fact that the tax law's flood of complexity is continuing unabated.

Another thing that we examined was the IRS' own measurements of how long it takes to prepare and file tax return. Now, as Bill Gale points out in his statement, these estimates are not perfect. But I do think it gives some indication of the trends. Look at the 1040 form with the fairly common schedules of A, B, and D where taxpayers report itemized deductions, interest, and dividend income as well as capital gains. In 1988, when the IRS started tracking this information, to this year's tax return, the average paperwork burden climbed from 17 hours and 7 minutes to 27 hours and 2 minutes, an increase of 58 percent. Even the short forms are becoming more complicated under these calculations. The so-called EZ form now requires 3 hours and 53 minutes, up from 1 hour and 31 minutes, a jump of 156 percent. I point out that these estimates are certainly incorrect, but they are the best that we have.

For example, the IRS reports that taxpayers only have to spend 1 minute understanding the earned income credit. Well, this is a provision of the tax law that the IRS reports has an extremely high error rate.

My statement details some of the suggestions as to how Congress can move toward simplification. I note that the '98 IRS Reform and Restructuring Act required Congress to at least consider complexity before passing tax legislation. The report on complexity that accompanied this year's tax legislation was an afterthought and an embarrassment. I think the Joint Committee could have done a much better job.

Clearly tax laws as they are being drafted are being driven by numbers—revenue loss estimates, revenue gain estimates, how the burden of the tax system is distributed, but there is nothing that requires, for example, complexity neutrality. So until you start getting driven by numbers on how complex things are, I suspect we will not see simplification.

Thank you very much.

[The prepared statement of Mr. Keating follows:]

Statement of David L. Keating, Senior Counselor, National Taxpayers Union

Mr. Chairman, and members of the Committee, thank you for holding this hearing on tax simplification and for inviting me to testify. Like old age, tax complexity has been creeping up on us. 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.

Sixty-five years ago the Form 1040 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 117 pages of instructions, triple the number in 1975 and more than double the number in 1985, the year before taxes were "simplified."

Form 1040—Form and Instructions

Tax Year	Lines 1040	Form Pages 1040	Instruction Booklet Pages 1040
2000	70	2	117
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

If you need help with something more complicated, the IRS prints at least 943 forms and instructions. UncleFed.com added up the length of these publications at our request and found a total of 12,933 pages for this tax-filing year alone.

Even the IRS is complaining about the burden. The new annual report of the IRS National Taxpayer Advocate identifies tax complexity for individuals and businesses as the number one and two most "serious problems encountered by taxpayers," and the "root cause" of the top twenty.

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. Once again, it appears that more taxpayers will use a tax pro this year. Through May 4, 56.7% of taxpayers used a pro, up from 55.8% at the same time last year. The more complex tax returns, which require professional assistance, are often filed within the statutory extension period, and final data on the use of paid professionals will become available in September.

The number of taxpayers using paid professionals has soared by 50% since 1980 and by 19% during the past decade. While some of this increase can be attributed to rising incomes, the growing use of home computers and tax preparation software has likely curtailed the rush to paid professionals.

The growth in the use of paid preparers can be accurately tracked because beginning in 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%
1995	49.9%
1999	56.2%
2000*	57.0%

*NTU estimate

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.

Tax preparation software has grown in sophistication as Windows 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, about 80% 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%
1999	76.3%
2000*	78.3%

*Through May 4

Tax Preparation Fees Are Rising Too

Tax preparation fees have increased substantially, largely due to the increased complexity of the average tax return. One way of tracking the trend in fees is to examine the average fees charged by H&R Block, the nation's largest tax preparation firm.

This rise in complexity has boosted profits at H&R Block, a publicly traded company. Last month, the company again raised its dividend and announced a two-for-one stock split. Its average $112 fee has increased 146% since 1985, or 48% after accounting for inflation. The sharp rise in fees is even more remarkable considering the huge increase in the capability of computers, tax return software, and printer speed. 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	Adjusted for Inflation
1985	$45.39	$75.33
1988	$49.21	$74.47
1998*	$84.39	$91.44
1999*	$92.57	$98.65
2000*	$101.29	$105.07
2001*	$111.51	$111.51

*Through April 15

Tax Complexity Will Probably Get Worse

Tax complexity probably will get worse before it gets better. Although the tax relief legislation enacted by Congress and the President this year would cut tax rates, it increases complexity. The long phase-in of the tax cut and long phase-out of the death tax will cause new tax planning headaches.

Income taxpayers will consider timing their incomes to take advantage of later-year tax rate cuts, while those concerned about the death tax must revise their estate plan to account for the gradual phase-out of the tax and its possible temporary repeal.

Because the tax cut would sharply reduce middle-class taxes, over 18 million more taxpayers (and 35.5 million by 2010) would be forced to complete a second tax return for the Alternative Minimum Tax (AMT), a parallel and complex tax system once aimed at ensuring the rich paid a substantial tax bill. As if one tax return weren't difficult enough already.

There are some positive steps that were taken to simplify the law. Notably the new law repeals the phase-out of the personal exemption and itemized deductions, though even the repeal of the phase-out is itself phased-in later this decade. The repeal was due in part to a fortunate coincidence of an excellent report by the Joint Committee on Taxation that contained recommendations for tax simplification with the need for a compromise on the highest tax rate bracket under the new law.

Federal 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 governmentwide 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 have soared by about 15% during the five years ending in 2000.

An earlier Paperwork Reduction Act passed in 1980 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 2000, total paperwork burdens for all agencies were estimated at 7,447.20 million hours, and the Treasury Department accounts for 6,131.85 million of these hours, or 82%.

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	5,909.07	3,897.31	10.8%	2,011.76
2000	6,131.85	3,702.45	15.0%	2,429.40

From the Information Collection Budget, Office of Management and Budget.
Target hours assume Treasury Department reductions meet the law's overall average reductions for all federal paperwork.

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 2,429 million hours.

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. 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 2000, the average paperwork burden hours climbed from 17 hours and 7 minutes to 27 hours and 2 minutes, an increase of 58%. The time burden has increased by 28% since 1995.

History of Estimated Preparation Time, 1040 Form and Common Schedules

Year	Record-keeping	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					
2000	7:52	7:16	10:05	1:49	27:02
1999	7:57	5:43	9:59	1:50	25:29
1995	7:04	4:36	7:11	2:21	21:12
1990	7:04	4:04	5:26	1:50	18:24
1988	6:56	3:39	5:02	1:30	17:07
Form 1040 only					
2000	2:45	3:25	6:16	0:35	13:01
1999	3:15	2:39	6:22	0:35	12:51
1995	3:08	2:54	4:43	0:53	11:38
1990	3:08	2:33	3:17	0:35	9:33
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 3 hours and 53 minutes, up from 1 hour and 31 minutes in 1988, a jump of 156%. The 1040A and Schedule 1 (interest and dividend income) has seen a paperwork burden increase of 35% since 1995.

History of Estimated Preparation Time, 1040EZ Form

Year	Record-keeping	Learning about the law or the form	Preparing the form	Copying, assembling, and sending the form to the IRS	Total
2000	0:05	1:38	1:50	0:20	3:53
1999	0:05	1:34	1:47	0:20	3:46
1995	0:05	0:55	1:22	0:20	2:42
1990	0:05	0:34	0:40	0:40	1:59
1988	0:07	0:24	0:40	0:20	1:31

History of Estimated Preparation Time, 1040A Forms

Year	Record-keeping	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					
2000	1:10	3:05	5:11	0:54	10:20
1999	1:11	2:44	4:45	0:55	9:35
1995	1:04	2:25	3:02	0:40	7:11
1992	1:42	2:24	3:20	1:22	8:48
Form 1040A and Schedule 1					
2000	1:29	3:08	5:11	0:54	10:42
1999	1:31	2:46	4:45	0:55	9:57
1995	1:24	2:27	3:08	0:55	7:54
1990	1:42	2:35	3:26	0:55	8:38
1988	1:53	2:16	3:12	1:10	8:31
Form 1040A only					
2000	1:10	3:04	4:58	0:34	9:46
1999	1:11	2:42	4:31	0:35	8:59
1995	1:04	2:23	2:58	0:35	7:00
1990	1:22	2:31	3:16	0:35	7:44
1988	1:20	2:11	2:52	0:35	6:58

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. In 1998, the last year *Money* administered the test, all forty-six tested tax professionals got a different answer, and not one got it right. The pro who directed the test admitted "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.

Steps Toward Simplification

While the 1998 IRS Reform and Restructuring Act requires Congress to at least consider complexity before passing tax legislation, that has not provided enough incentive for Congress to avoid additional complexity or encourage simplification. The report on complexity that accompanied this year's tax legislation was an afterthought and an embarrassment.

The tax-writing committees should be required to quantify the costs of proposals that add complexity or the savings from proposals that simplify the law.

The report on simplification by the Joint Committee on Taxation this year proves the worth of giving Congress trusted recommendations on this important issue. Several of the report's recommendations were included in the new tax cut law. Congress should look for ways to encourage both the Joint Committee and the Treasury Department to offer more such recommendations.

The National Commission on Restructuring the IRS suggested that Congress consider a quadrennial simplification process, and Congress and the President should 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.

Conclusion: 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.

Chairman HOUGHTON. Thank you. We have a vote. So why don't we go ahead with your statement, Mr. Moody, and then if people want to peel off, fine. If not, we will finish with that, go and have a vote and come back. So go right ahead, please.

STATEMENT OF SCOTT MOODY, SENIOR ECONOMIST, TAX FOUNDATION

Mr. MOODY. Thank you, Mr. Chairman and Members of the Committee. My name is Scott Moody. I am the Senior Economist of the Tax Foundation. It is an honor for me to appear before your Committee today on behalf of the Tax Foundation to discuss the cost of tax complexity on taxpayers.

The Tax Foundation's goal is to explain as precisely and as clearly as possible the current state of fiscal policy in light of established tax principles so that you, the policy makers, have the information to make informed decisions. Among these principles, a good tax system should be as simple and as stable as possible.

The Tax Foundation has worked on estimating how much it costs both individuals and businesses to read the rules, fill out the forms and do all the other things necessary to comply with the Nation's tax laws in time for the April 15th deadline. Many studies of the Tax Code find that our system, particularly the income Tax Code, is excessively complex. In 2001, individuals and businesses will spend an estimated 4.6 billion hours complying with the Federal income tax with an estimated cost of compliance of over $140 billion. This amounts to imposing a 12-cent administrative burden for every dollar that the income tax system collects.

To put this tax compliance burden into perspective, the 140 billion tax surcharge is greater than the combined revenue of Sears, Walt Disney, Microsoft, Rite Aid, McDonald's, 3Com and Radio Shack. Put another way, 4.6 billion hours per year represents a work force the equivalent of over 2.2 million people. That is more people than would reside in four congressional districts.

The Tax Foundation has also projected future compliance costs out to 2006 as shown in the chart here to my left. Over this time period compliance costs will grow by almost $30 billion from 140 billion in 2001 to 170 billion in 2006.

To illustrate the magnitude of these compliance costs the chart also compares the year-to-year cost with that of the recently enacted tax reduction. In every year between 2001 and 2006 the total tax compliance cost is greater than the tax reduction. So from the taxpayers' perspective the recent tax cut represents only a partial refund of their total yearly tax compliance burden. In fact, the cumulative compliance burden over this time period will come to almost $930 billion while the cumulative tax relief over the same period will only cover a little more than half that cost, or roughly $550 billion.

Because complying with the tax laws represents a fixed cost for many individuals, it seems likely that lower income individuals would bear a greater relative tax burden than higher income individuals. In previous research, the Tax Foundation has found this to be true of corporations. New research by the Tax Foundation finds that the same is also true for individuals. As you can see in the second chart, the compliance costs of individuals is quite regressive. As a percent of adjusted gross income, taxpayers with AGI of less than $20,000 are hit the hardest. They pay a compliance tax surcharge of over 4 percent of their income, because compliance costs are essentially a fixed cost.

The compliance tax surcharge falls as income increases. For taxpayers with $40,000 to $75,000 in income their surcharge consumes a much lower 1 percent. The surcharge drops to two-tenths of a percent for taxpayers with incomes over $200,000.

As in chart 1, chart 2 compares the distribution of the individuals' compliance costs to the distribution of the recent tax reduction. Chart 2 illustrates that a very effective way to provide tax relief for lower income taxpayers is via tax simplification. In fact, nearly half of the tax surcharge savings resulting from tax simplification would go to taxpayers with less than $40,000 in income. For example, Form 1040, which accounts for almost half of the tax compliance burden on individuals, takes nearly 13 hours to complete. Every hour shaved off the 1040 would save taxpayers over $2 billion a year. A mere 3-hour savings would net a 10-year $60 billion windfall for taxpayers at zero cost to the U.S. treasury.

In addition to the tax surcharge itself, the tax complexity due to the size and instability of the Tax Code creates two other economic costs. I don't measure these costs in my testimony, but they are significant enough to keep in mind. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty in the Tax Code.

In conclusion, the benefits of reducing the tax complexity burden would dramatically benefit lower income taxpayers, since they bear a disproportionate amount of the burden. Overall, though, taxpayers in all income brackets would benefit from a tax reduction via tax simplification. This could be done under a comprehensive revision of the Tax Code guided by established tax principles such as those supported by the Tax Foundation.

Thank you very much.

[The prepared statement of Mr. Moody follows:]

Statement of Scott Moody, Senior Economist, Tax Foundation

Mr. Chairman and Members of the Committee, my name is Scott Moody and I am the senior economist at the Tax Foundation. It is an honor for me to appear before your committee today on behalf of the Tax Foundation to discuss the cost of tax complexity on taxpayers.

The Tax Foundation is a non-profit, non-partisan research and public education organization that has monitored fiscal policy at all levels of government since 1937. The Tax Foundation is neither a trade association nor a lobbying organization. As such, we do not take positions on specific legislative proposals. The Tax Foundation does not receive any federal funds.

Our goal is to explain as precisely and as clearly as possible the current state of fiscal policy in light of established tax principles, so that you, the policy makers, have the information to make informed decisions. Among to these principles, a good tax system should be as simple and stable as possible.

As such, the Tax Foundation has worked on estimating how much it costs both individuals and businesses to read the rules, fill out the forms, and do all the other things necessary to comply with the nation's tax laws in time for the April 15th tax filing deadline. My testimony will provide the results of our work to date on the cost of tax compliance.

It is important for the public to have an estimate of this cost because the performance of the economy is dramatically affected by the state of tax law. If lawmakers create an Internal Revenue Code that is terribly complex or that changes rapidly, taxpayers may not be able to obtain a reasonably certain conclusion about how taxation will affect a business plan or investment. When the tax consequences of various economic activities are unpredictable, then tax policy is handicapping the growth and dynamism of the U.S. economy.

As if the complexities inherent in taxing income did not pose a sufficiently daunting challenge to the writers and administrators of the tax code, political and social demands have also been taken into account. In particular, two goals for the code that contribute to complexity are "fairness" and social utility. They come into play when determining how much individual taxpayers should owe—the "ability-to-pay" principle, and when providing incentives for socially beneficial activities.

Many studies of the tax code find that our system, particularly the income tax code, is excessively complex. This study concurs, quantifying the code's complexity in a way that makes clear how unnecessary much of it is. In 2001 individuals and businesses will spend an estimated 4.6 billion hours complying with the federal income tax, with an estimated cost of compliance of over $140 billion. This amounts to imposing a 12-cent administrative burden for every dollar the income tax system collects.

If the high cost of complying with the federal income tax were a necessary price to pay for a fair and effective tax system, perhaps there would be little room for complaint, but in fact the complaints are justified.

The Complications of the Federal Income Tax

Most Americans naturally think of their income tax burden simply as the amount at the bottom line of their 1040 form. Economists, on the other hand, may express Americans' tax burden as a percentage of GDP or even as a date on the calendar, such as Tax Freedom Day. But such measures fail to register another cost to taxpayers—the cost of complying with the tax system.

Experts complained about the complexity of the federal income tax system as early as 1914, the year immediately following the adoption of the 16th Amendment to the Constitution which authorized the income tax. Since then, the quest for tax simplification has waxed and waned with generally little progress over the years and the tax code has grown in complexity. Veteran tax professionals commonly point to the Tax Reform Act of 1969 as the legislation that infused much needless complexity into the income tax code. But they say nothing in that Act came anywhere near the bewildering complexities that were introduced by the tax enactments of the 1980s.

Within a three-year period in the first half of the 1980s, the income tax code was subjected to three massive pieces of legislation. First was what became known as "the Reagan tax cut," the Economic Recovery Tax Act of 1981. This was followed immediately by the Tax Equity and Fiscal Responsibility Act of 1982, and soon thereafter came the Deficit Reduction Act of 1984. However, the tax drama had not yet reached its climax, which occurred in 1986 with the enactment of the Tax Reform Act of 1986 (TRA'86).

TRA'86 was meant to make a clean break from the past complexity and instability in the tax code. The primary goal of its authors was tax simplification, and toward that end, the act reduced the number of rates and expanded the tax base (through the elimination of numerous tax preferences). While the goal was laudable, the nation did not end up with a simpler tax code—especially from the perspective of businesses. Previous research by the Tax Foundation has found that there is near unanimity among senior corporate tax officers that TRA'86 brought tax complexity to an unprecedented level. They point to the alternative minimum tax, inventory capitalization rules, and foreign income rules as the main culprits.

The Complex Job of Taxing Income

In 1927, the Joint Committee on Internal Revenue Taxation (Vol. 1, p. 5) reported that: "It must be recognized that while a degree of simplification is possible, a simple income tax for complex business is not." This early recognition of how difficult it is to tax income bears repetition and elaboration.

The Problem of Defining Income

Income tax complexity is almost wholly related to tax base questions—that is, questions or uncertainty about the timing or definition of taxable transactions. The inherent complexity of an income tax results from the difficulty of defining income and determining when and to whom to recognize income and expense for tax purposes. Over time, the political process of give-and-take has made these difficult tax base questions inordinately complex. The definition of taxable income has not only expanded dramatically, but it has undergone chronic change.

Non-Economic Demands on the Code

In addition to the inherent complexities of taxing income, an important political goal of our tax system is to ensure that the income tax code is both fair and equitable. This goal comes into play in two important areas of the tax code that contribute to complexity: (1) determining how much individual taxpayers should owe—the "ability-to-pay" principle, and (2) providing incentives for socially beneficial activities.

Ability to Pay

From an economic perspective, the most efficient way to levy taxes is with a head tax. In other words, every person would pay an equal lump-sum tax. According to recent Tax Foundation research, if such a head tax were instituted today, every man, woman and child in the nation would have to pay $11,116 to fund the government at current levels. The federal government alone would account for almost 70 percent ($7,754) of the tax bill with state and local governments accounting for the remainder ($3,362).

Economists would call such a head tax efficient because it is economically neutral, avoiding all distortion of the free-market process. In other words, the burden of a head tax does not fall on any particular economic activity, so taxpayers' economic decisions would be completely unaffected by the tax system. Even the simplest income tax could never be 100 percent economically neutral precisely because the burden of the tax falls on income-producing activity, inevitably persuading some taxpayers in some circumstances to earn less income.

Obviously, such a head tax would be administratively efficient as well, as neither taxpayers nor the government would need to document taxpayers' income. However, the head tax is politically troublesome, to put it mildly. Taxation anywhere near the current level would constitute an insuperable burden for low-income citizens. If television stars and day laborers must pool their resources to fund government operations that consume roughly one third of the nation's income, as they now do, then devising a tax system that takes "ability to pay" into account becomes inevitable, even if it does lead to a much more complex tax code.

Today the tax code includes a multitude of provisions to adjust the tax burden according to this "ability-to-pay" principle. The most obvious application of this principle is the graduated rate structure which increases a taxpayer's liability as a percentage of income as income rises. Other provisions adjust for the number of children in the family, family status (single, married, head of household), etc.

Promoting Socially Useful Activities

In addition to making allowances for the poor, today's income tax code includes numerous provisions to encourage activities that are deemed "socially beneficial." In the personal code, taxpayers are allowed various credits and deductions such as home mortgage interest, health care expenditures and the child tax credit, to name a few. On the business side, there are various credits—such as the investment tax credit—and preferential depreciation rules. As a result, the income tax code today is a hodgepodge of deductions and credits that have nothing to do with raising the revenue needed to fund government operations. In fact, these tax code items not only reduce revenues but at the same time dramatically increase the complexity of the tax code.

Unfortunately, once inserted into the code, these preferential tax provisions become entrenched over time as various groups lobby for their protection and expansion.

To economists this is known as rent-seeking. Such lobbies have a strong interest in maintaining the tax preference because they have usually spent substantial resources obtaining it. Also, the general public usually mounts little opposition since the benefits are concentrated on a relatively small group of taxpayers while the costs are spread amongst everyone else.

For example, let's look at the tax complexity caused by the ever-popular deduction for charitable contributions. As for any itemized deduction, taxpayers must keep an accurate accounting of their charitable contributions. If the value is over $250, the taxpayer also needs a statement from the charitable organization. While such record-keeping does not appear overly onerous, just look at some of the problems lurking in the background.

For one, charitable contributions are a significant source of "tax leakage," a term the Internal Revenue Service uses when it refers to the loss of tax revenue caused by under-reported income or over-reported deductions. For instance, a phantom donation of $25 a week would lead to a deduction of $1,300 a year. Obviously, if a significant number of taxpayers did this, the revenue loss would be quite significant. Not all tax evaders are as blatant as the tax lawyer who was recently caught claiming to have given his church $500 every Sunday—when the IRS inquired, the pastor of the taxpayer's church was not obliged to keep his parishioner's sin a secret. Such over-reporting of deductions leads to higher compliance costs for all taxpayers as the IRS has to resort to increased auditing and/or the addition of more rules and regulations.

Charitable organizations have to go through an approval process administered by the IRS before a contribution by an individual can be legally declared as a charitable deduction. The burden of this process is not a one-time cost because every approved charity has to be aware at all times that even the slightest change in its mission could nullify its charitable status according to the IRS. Of course, this process is costly, in time and money, for the charities and the IRS.

The rules and regulations governing the deduction not only add to the complexity in the tax code, but naturally, the deduction also lowers government revenue, forcing everyone else to pay higher tax rates. However, while there are a multitude of organizations that stand ready to defend the deductibility of charitable contributions, there are no large groups of taxpayers that oppose its complexity.

The complexity caused by this one popular deduction is like the proverbial tip of the iceberg. There are literally thousands of similar special preferences written into the tax law that promote various activities or benefit a group of taxpayers. These groups of taxpayers stand ready to defend their tax preferences with economic and emotional arguments that relate to the taxpayers' ability to pay or the social benefits of the activity in question. This organized resistance to simplification has been phenomenally successful over many years, causing many legislators to despair of piecemeal efforts at tax simplification.

Fundamental Tax Reform

One way to get around the problems caused by rent-seeking, thereby reducing complexity and its attendant costs in the income tax code, is to reform the entire federal income tax system. Reform proposals are currently on the table that attempt to make simplification and the promotion of economic growth the principal strategies of tax policy. These include the national sales tax sponsored by Rep. Billy Tauzin and the flat income tax proposal sponsored by Rep. Dick Armey.

The national sales tax takes the direct approach and moves away from the concept of taxing income completely—taxing consumption instead. The flat tax, on the other hand, moves to cash flow as the tax base, rather than accrued income. A cash flow tax, as it applies to business, totals business receipts and then subtracts purchases from other businesses. On the individual level, the approach resembles a universal IRA.

Both proposals would boost economic performance by eliminating the double tax on savings, and both promise huge reductions in the complexity of the tax code. As of this writing, however, neither plan has garnered widespread support. Even if a plan to fundamentally simplify the tax system did gain momentum, the possibility exists that provisions would be added during the legislative process that would add new complexity, such as happened in 1986.

The Growth and Instability of the Income Tax Code

Despite decades of concern over its undue complexity, the income tax was formally placed at the core of the federal tax system by the Internal Revenue Act of 1954. Overall, two important measures of tax complexity have climbed dramatically since then—the size and the instability of the tax code.

The Growth of the Code

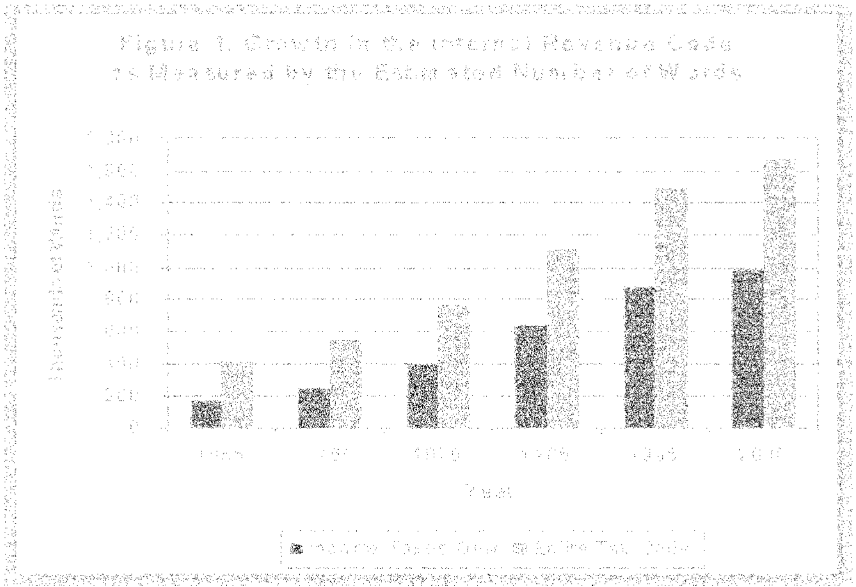
Table 1, Figure 1 and Figure 2 chart the dramatic growth over the past 40 years in the combined number of words that define the body of both the federal income tax laws and their attendant regulations. Since 1954, the estimated number of words in the entire tax code devoted to the income tax has grown from 42 percent to 59 percent, more than a 40 percent increase over the last four decades. The volume of income tax regulations has grown even more. In 1954, income tax regulations represented 55 percent of the body of tax code regulations. Today, that figure has grown to 81 percent, an increase of more than 47 percent over the past four decades.

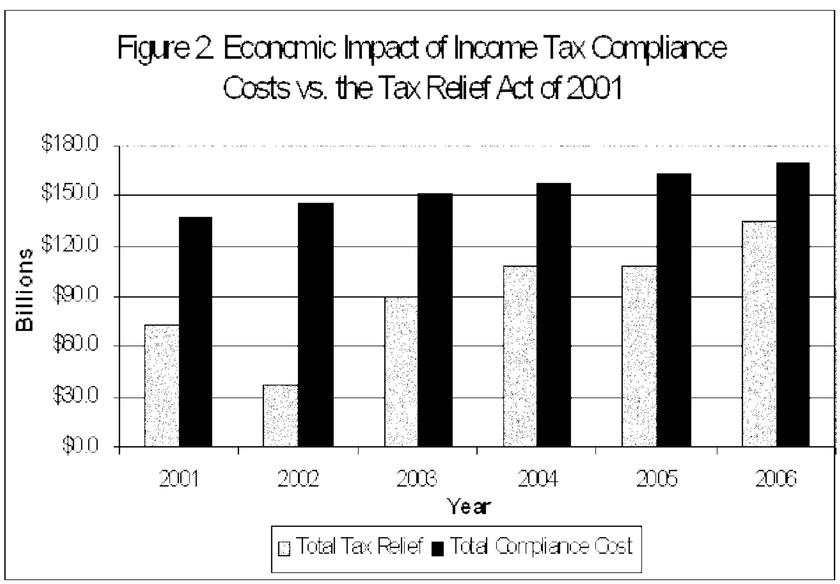
Table 1

Growth of the Number of Words in the Internal Revenue Code Selected Years, 1955–2000

	1955	1965	1975	1985	1995	2000
Internal Revenue Code						
Income Taxes Only	172	243	395	645	881	982
Entire Tax Code	409	548	758	1,107	1,488	1,670
Period-to-Period Percent Growth						
Income Taxes Only	*	41.4%	62.8%	63.2%	36.6%	11.5%
Entire Tax Code	*	33.8%	38.3%	46.0%	34.5%	12.2%
Internal Revenue Code Regulations						
Income Taxes Only	572	1,715	2,571	3,762	4,880	5,947
Entire Tax Code	1,033	3,098	3,295	4,613	6,135	7,307
Period-to-Period Percent Growth						
Income Taxes Only	*	199.6%	49.9%	46.3%	29.7%	21.8%
Entire Tax Code	*	199.9%	6.4%	40.0%	33.0%	19.1%
Internal Revenue Code and Regulations						
Income Taxes Only	744	1,957	2,966	4,406	5,761	6,929
Entire Tax Code	1,442	3,646	4,053	5,720	7,623	8,976
Period-to-Period Percent Growth						
Income Taxes Only	*	163.1%	51.5%	48.6%	30.8%	20.3%
Entire Tax Code	*	152.8%	11.2%	41.1%	33.3%	17.7%

Source: Tax Foundation calculations based on the annual publications of "Internal Revenue Code" and "Federal Tax Regulations" from West Publishing Company.





The Tax Foundation has determined that over the past 45 years the number of words detailing the income tax laws has grown from 172,000 words in 1955 to 982,000 today—an increase of 472 percent. Income tax regulations, which provide taxpayers with the “guidance” they need to calculate their taxable income, have grown at an even faster pace from 572,000 words in 1955 to 5,947,000 words today—an increase of 939 percent. Combined, the federal income tax code and regulations grew from 744,000 words in 1955 to 6,929,000 today—an increase of 831 percent.

Growth of the Code by Subject Area

Perhaps a more revealing measure of tax code complexity is the multiplication of the subchapters and subsections that comprise the Internal Revenue Code. In 1954, federal income tax law was comprised of 103 code sections. Today, there are 725 income tax code sections, a 604 percent increase. (See Table 2.)

Table 2

Comparison of 1954 Code and 2000 Code

	Number of Sections in Subchapter		Percent Growth
	1954	2000	
Subchapter of Income Tax Code			
Determination of Tax Liability	4	50	1150%
Computation of Taxable Income	9	152	1589%
Corporate Distributions and Adjustments	14	35	150%
Deferred Compensation	2	31	1450%
Accounting Periods and Methods	6	33	450%
Tax-Exempt Organizations	4	19	375%
Corporation Used to Avoid Income Tax on Shareholders	4	27	575%
Banking Institutions	3	8	167%
Natural Resources	3	10	233%
Estates, Trusts, Beneficiaries, Etc.	7	32	357%
Partners and Partnerships	7	36	414%
Insurance Companies	5	30	500%
Regulated Investment Companies, Etc.	1	22	2100%
Tax Based on Income from Within or Without the United States	9	79	778%
Gain/Loss on Disposition of Property	7	40	471%
Capital Gains and Losses	4	56	1300%
Readjustment of Tax Between Years and Special Limitations	6	7	17
Tax Treatment of S Corporations	0	14	NA
Other (a)	8	44	450%
TOTAL	103	725	604%

(a) Includes all subchapters not explicitly listed as well as Chapters 2–6 of Subtitle A of the Internal Revenue Code.
Source: Tax Foundation computations from Internal Revenue Code

Almost all of the growth relates to tax base questions. For example, since 1954, the number of sections dealing with the "Determination of Tax Liability" has grown 1,150 percent; the number of sections dealing with "Capital Gains and Losses" has grown 1,300 percent; the number of sections dealing with "Deferred Compensation" (e.g., pension plans) has grown 1,450 percent; and the number of sections dealing with the "Computation of Taxable Income" has grown by more than 1,589 percent.

The growth in the volume of the income tax laws and regulations is a direct result of the 32 significant federal tax enactments that have taken place since 1954—or approximately one every 1.4 years. Previous Tax Foundation research (based on a sample of one-fifth of the core sections of the income tax code) found that these enactments have not only increased the volume of the tax code, but resulted, on average, in the amendment of each section once ever four years (as of 1994). This instability has been much more pronounced in the past 20 years than it was during the 20 years immediately following the 1954 Act.

Quantifying the Cost of Tax Compliance

The complexity generated by the growth and constant change of the tax code creates two general types of economic cost: overhead and opportunity cost. Overhead can be divided into three principal activities: the economically sterile exercises of tax planning, compliance, and litigation, all of which act like tax surcharges on taxpayers.

- The first type of overhead is tax planning, which in this context refers to all the economic decisions that individuals and firms make because of the tax code.

- The second type of overhead, tax compliance, refers here to the basic actions required to comply with the federal income tax, including record keeping, education, form preparation and packaging/sending.
- The third type of overhead is litigation, referring to the cost of the IRS and the Tax Court, as well as all the legal costs that taxpayers incur while dealing with these two government institutions.

Of these three costs, the second—tax compliance—is the only one estimated in this report. It is for this reason that the data presented here should be viewed as extremely cautious estimates of the federal income tax compliance burden on taxpayers.

For example, a company plans to build a manufacturing facility. However, after tax planning, the decision is reached to build a slightly different facility in a different location. The company later files a tax return on the activities of the facility, but the IRS objects to some aspect of the tax return, and after some legal wrangling, the return is finalized. In this case, only the firm's costs of actually calculating and filing its tax return are part of the Tax Foundation's estimate of the "cost of compliance."

As for the second general type of economic cost caused by the tax system—opportunity costs—they are also excluded from Tax Foundation estimates of the compliance burden. Arriving at an estimate of opportunity costs is a much more difficult and speculative task.

For instance, imagine a software developer who has to spend time complying with the tax code. Data are available to compute an estimated value of the tax work he accomplishes, and this report does that. But it is not possible to estimate with any precision the value of the work that the taxpayer might have accomplished had tax compliance not replaced entrepreneurial effort. This time may have been spent working on a new idea that one day blossomed into the next Microsoft—creating tens of billions of dollars in wealth. And even if phenomenal wealth would not have been created in that time, it is still true that every hour or dollar spent complying with the tax code represents resources that could have been spent tending to business problems, adding value to the economy while doing the work that the taxpayer is good at.

As shown in Tables 3 and 4, the Tax Foundation estimates that in 2001 individuals and businesses spent over 4.6 billion hours complying with the federal income tax. Using an hourly cost of $25.21 for individuals and $36.20 for businesses, the estimated cost of compliance in 2001 is $140 billion. (See Methodology section for details about how the hours and wages were determined.) Therefore, the overall compliance cost surcharge alone amounts to nearly 12 cents for every $1 collected by the federal income tax.

Table 3

Estimated Cost to Individuals for the Federal Income Tax System, 2001

Individuals	Number of Returns	Record keeping	Education Stage	Form Preparation	Packaging/Sending	TOTAL	Total Hours
Forms							
1040(a)	77,914,480	2.8	3.4	6.3	0.6	12.0	936,272,335
1040A (b)	14,702,000	2.3	3.5	6.5	2.0	14.3	209,993,567
1040EZ (c)	16,660,000	0.1	1.6	1.8	0.3	3.9	64,696,333
1040ES	43,251,000	1.3	0.3	0.8	0.2	2.6	111,731,750
1040X	3,274,000	1.3	0.5	1.2	0.6	3.6	11,622,700
4868 (Extension of Time) (d)	8,333,000	0.4	0.2	0.3	0.2	1.1	9,027,417
2688 (Extension of Time) (e)	3,066,000	0.0	0.2	0.3	0.3	0.8	2,350,600
1041 (Estates and Trusts)	3,670,000	46.6	18.5	35.0	4.3	104.4	383,025,667
1041ES	2,017,000	0.3	0.3	1.5	1.0	3.1	6,252,700
1040 Schedules							
Sch A	52,017,347	3.1	0.7	1.6	0.3	5.6	292,164,098
Sch B	53,939,047	0.6	0.1	0.4	0.3	1.4	77,312,634
Sch D	35,277,366	1.5	3.1	1.8	0.6	7.0	245,765,650
Sch E	21,135,796	3.1	1.0	1.4	0.6	6.1	127,871,564

Estimated Cost to Individuals for the Federal Income Tax System, 2001—Continued

Individuals	Number of Returns	Record keeping	Education Stage	Form Preparation	Packaging/Sending	TOTAL	Total Hours
Sch EIC	23,026,802	0.0	0.0	0.2	0.3	0.6	13,048,521
Sch H	436,280	1.6	0.5	0.9	0.6	3.6	1,563,337
Sch R	592,602	0.3	0.3	0.5	0.6	1.6	967,917
Estate and Gift							
706 and 706NA (Estate)	121,000	12.4	7.6	14.6	10.6	45.3	5,477,267
709(Gift)	300,000	0.7	1.1	1.9	1.1	4.7	1,410,000
Individual Totals	359,733,721	NA	NA	NA	NA	NA	2,500,554,057

(Forms + Schedules)
(a) Includes 1040PC and electronically filed 1040 forms.
(b) Schedules 1–3 are included in the average time.
(c) Includes Telefiled 1040EZ forms.
(d) Application for automatic extension of time in which to file the individual income tax return.
(e) Application for additional extension of time in which to file the individual income tax return.
Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

Table 4

Estimated Cost to Business for the Federal Income Tax System, 2001

Businesses	Number of Returns	Record keeping	Education Stage	Form Preparation	Packaging/Sending	TOTAL	Total Hours
Sole Proprietorships							
Form 1040	19,775,520	2.8	3.4	6.3	0.6	13.0	257,411,352
Sch C	15,488,696	6.0	1.4	2.3	0.7	10.4	160,824,293
Sch C–EZ	2,535,193	0.8	0.1	0.6	0.3	1.7	4,352,081
Sch F	1,751,631	3.5	0.5	1.4	0.3	5.8	10,203,253
Sch SE	19,245,221	0.3	0.3	0.4	0.3	1.3	24,216,903
Partnership							
Form 1065	2,132,000	39.9	22.2	37.8	4.0	104.0	221,656,933
Part. Schedules							
Sch D	2,132,000	6.9	2.2	2.4	0.0	11.5	24,518,000
Sch K–1	2,132,000	27.0	10.1	11.0	0.0	48.2	102,762,400
Sch L	2,132,000	15.5	0.1	0.4	0.0	16.0	34,112,000
Sch M–1	2,132,000	3.4	0.2	0.3	0.0	3.8	8,137,133
Sch M–2	2,132,000	2.9	0.1	0.2	0.0	3.1	6,644,733
Corporations Forms							
1120	2,270,000	71.5	42.0	73.0	8.0	194.5	441,590,667
1120A	259,000	44.2	23.6	41.1	4.6	113.5	29,387,867
1120S	2,856,000	63.4	21.4	39.2	4.6	128.4	366,805,600
1120X	14,000	12.4	1.4	3.6	0.5	18.0	251,533
1120F	23,000	107.6	40.5	70.1	7.5	225.8	5,192,250
1120FSC	6,000	94.0	18.5	36.4	0.0	148.9	893,300
1120POL	5,000	17.0	5.1	12.1	1.9	36.0	179,750
1120RIC	11,000	56.9	18.5	34.2	4.0	113.7	1,250,700
7004 (Extension of Time) (a)	2,900,000	5.7	1.4	2.5	0.3	9.8	28,468,333
4626 (AMT)	363,200	18.2	12.2	13.1	0.0	43.4	15,774,987
4562 (Depreciation)	2,529,000	37.3	5.2	6.0	0.0	48.5	122,572,200
1120 Schedules							
Sch D	2,270,000	7.2	4.1	6.3	0.5	18.1	41,011,333
Sch H	227,000	6.0	0.6	0.7	0.0	7.3	1,649,533
Sch PH	113,500	15.3	6.2	8.6	0.5	30.6	3,474,992
1120S Schedules							
Sch D	2,856,000	10.5	4.6	9.7	1.3	26.1	74,636,800
Sch K–1	2,856,000	15.5	10.4	2.1	1.1	29.1	83,062,000

Estimated Cost to Business for the Federal Income Tax System, 2001—Continued

Businesses	Number of Returns	Record keeping	Education Stage	Form Preparation	Packaging/ Sending	TOTAL	Total Hours
Business Total .... (Forms + Schedules)	91,146,961	NA	NA	NA	NA	NA	2,071,040,927
GRAND TOTAL	450,880,682	NA	NA	NA	NA	NA	4,571,594,984

(a) Application for automatic extension of time in which to file the corporate income tax return.
Source: Tax Foundation, using Internal Revenue Service data and estimation methods.

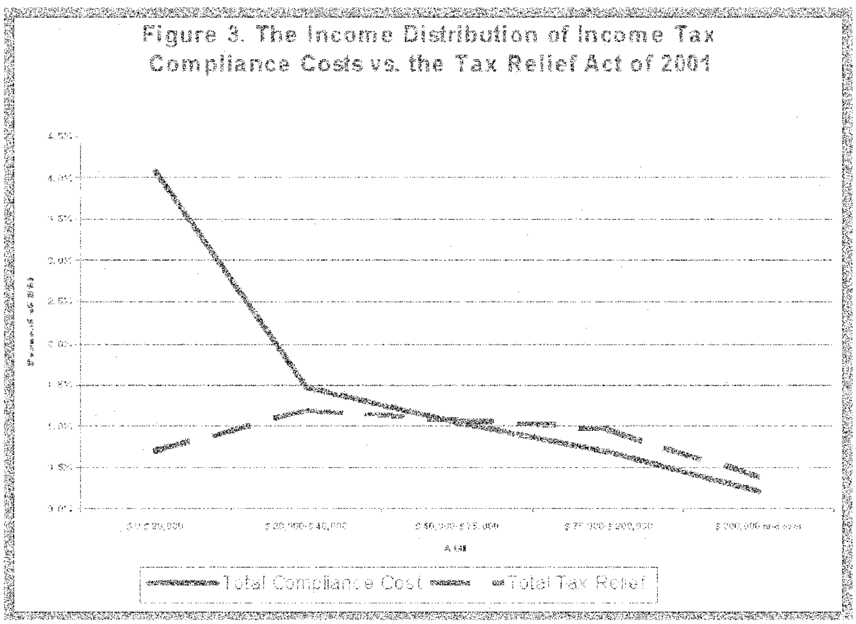


Figure 3. The Income Distribution of Income Tax Compliance Costs vs. the Tax Relief Act of 2001

To put the tax compliance burden into perspective, the $140 billion tax surcharge is greater than the combined revenue of Sears ($40.9 billion), Walt Disney ($25.4 billion), Microsoft ($22.9 billion), Rite Aid ($14.7 billion), McDonalds ($14.2 billion), 3 Com ($5.4 billion) and Radio Shack ($4.8 billion). Put another way, 4.6 billion hours per year represents a work force of over 2,235,000 people, larger than the populations of Dallas (1,076,000) and Detroit (965,000) combined, and more people than work in the auto industry, the computer manufacturing industry, the airline manufacturing industry, and the steel industry combined. This is also more people than would reside in four Congressional districts.

In addition, the Tax Foundation has projected future compliance costs out to 2006. These projections are based on estimates published by the Internal Revenue Service (see Methodology section). As Shown in Figure 2, compliance costs will grow by almost $30 billion from $140 billion in 2001 to $170 billion in 2006.

To illustrate the magnitude of these compliance costs, Figure 2 also compares the year-to-year compliance cost with that of the recently enacted tax reduction. In every year between 2001 and 2006, the total tax compliance cost is greater than the tax reduction. So from the taxpayer's perspective, the recent tax cut represents only a partial refund of their total tax compliance burden. The cumulative compliance cost over the 2001–2006 period will come to almost $930 billion while the cumulative tax reduction over the same period will only cover a little more than half the compliance costs at $550 billion.

Who Bears the Burden of Tax Compliance

Because complying with tax laws represents a fixed cost for many individuals, it seems likely that lower income individuals would bear a greater relative compliance burden than higher income individuals. In previous research, the Tax Foundation has found this to be true in corporate compliance costs. In fact, in 1996, small corporations—those with less than $1 million in assets—spent at least 27 times more on compliance costs as a percentage of assets than the largest U.S. corporations. New research by the Tax Foundation finds the same is true for individuals.

As shown in Figure 3, the compliance cost on individuals is quite regressive (see Methodology section). In other words, the compliance cost hits lower income individuals harder than higher income individuals. In fact, taxpayers with less than $50,000 of adjusted gross income (AGI) pay almost 60 percent of the total compliance cost for individuals—$37 billion of the total $65 billion compliance cost imposed on individuals.

As a percentage of AGI, taxpayers with AGI of less than $20,000 are hit the hardest. They pay a compliance tax surcharge of over 4 percent of their AGI. Because compliance costs are essentially a fixed cost, the compliance tax surcharge falls as AGI increases. For taxpayers with $40,000–$75,000 in AGI, their surcharge consumes a much lower 1 percent of their AGI. The surcharge drops to 0.2 percent for taxpayers with an AGI of over $200,000.

This result occurs for two reasons. First, 75 percent of all returns are filed by taxpayers with less than $50,000 in AGI. Secondly, taxpayers with less than $50,000 in AGI only account for 33 percent of total AGI. Therefore, the fixed cost nature of tax compliance has a larger negative impact on lower income individuals.

Again, for illustrative purposes, the distribution of the individual compliance costs is compared to the distribution of the recent tax reduction. This comparison is made for year 2001 which is an appropriate comparative year because the majority of the tax cuts were aimed at individuals—particularly lower income taxpayers with the retroactive implementation of the lower 10 percent bracket.

Figure 3 reveals that a more effective way to provide tax relief to lower income taxpayers is via tax simplification. In fact, nearly half of all the tax surcharge savings resulting from tax simplification would go to taxpayers with less than $40,000 in AGI. For example, Form 1040—which accounts for almost half of the tax compliance burden on individuals—takes nearly 13 hours to complete. Every hour shaved off the 1040 would save taxpayers over $2 billion. A mere 3 hour savings would net a ten-year $60 billion windfall for taxpayers—at zero cost to the U.S. Treasury. Every hour shaved would also save taxpayers some 80 million hours a year—time better spent with family or tending to business.

Measures to Reduce the Cost of Compliance

What can be done to reverse the current situation? To reduce tax compliance costs, lawmakers and regulators must focus on the causes of tax complexity. One set of causes is economic and the other set is political.

As explained earlier, the economic causes of complexity are inherent in an income tax itself. The tax base questions, "What is income?" "When is it income?" are difficult to answer—especially on the corporate side. The inherent difficulty of these questions explains why, for example, the rules of depreciation and the rules of transfer pricing associated with foreign-source income create such mind-boggling tax code complexity.

However, the political process, particularly the politics the deficit/surplus debate, has made an inherently complex tax system worse. To a vast degree, the complexity of the current tax code is a by-product of the era of chronic federal budget deficits. The drive to balance the budget placed a policy emphasis on increasing on increasing government revenue, rather than on refining and promulgating consistent definitional answers about income. In this sense, tax policy has become tactical rather than strategic. Tax policy has no unifying theme. Instead, the budgetary aspects of dealing with the tax system are generally controlling the policy process.

This past budgetary dynamic has combined with the issue of tax fairness and the normal course of lobbying to accelerate the trend of "created complexity" and the artificial expertise that necessarily accompanies it. And this artificial expertise creates its own problems with regard to tax code complexity.

The interplay of these forces works something like this: Under budgetary rules, nothing can be done unless it is paid for. To date, however, cutting spending has rarely been a realistic political option, so inventive ways are found to raise revenue.

Often, such revenue-raising exercises amount to broadening the tax base in some ad hoc or indirect way—like the AMT—since raising rates or removing tax preferences in a straight-forward manner would face clear and powerful opposition.

Naturally, when the individuals or businesses that will be affected by the tax changes get wind of the proposals, they lobby to change the proposal, or shift the tax burden altogether. These activities may further contort the tax proposals.

When the final provisions are passed into law, the regulating agencies must devise ways to administer them. When the regulations are drawn up so as to be comprehensive—that is, when they attempt to cover every contingency while attempting to assure a zero possibility that a taxpayer can avoid taxation—the result is complex regulation superimposed on complex (or vague) legislation.

The net result of this process over time, is that few, if any, of the tax writers—the "artificial" experts—understand the mechanics of the entire tax code. The tax writing specialists become comfortable in dealing only with their own narrow specialty. Tax specialists begin writing detailed rules with other tax specialists in mind. This narrow focus explains why, on occasion, there are complete inconsistencies in the Internal Revenue Code. No one person is capable of grasping the entire body of law. In this way, complexity seems to beget further complexity.

Short of overhauling the entire federal tax system, Congress can work to reduce the complexity of the current tax system (and, therefore, its high compliance costs) through two courses of action. First, Congress should strive to achieve a much larger measure of tax stability. Although not measured in this testimony, the taxpayer uncertainty that results from frequent tax law changes is a key source of complexity. Second, legislators and regulators should place a larger emphasis on tax simplicity. There exists an inherent trade-off between completeness and simplicity. In their steady pursuit of tax revenue and tax "fairness," legislators and regulators have emphasized completeness by trying to shut off all avenues of tax avoidance without regard to the incremental costs or unintended consequences of such an approach to governance.

Conclusion

Current forecasts of compliance costs on taxpayers reveal a large and growing tax compliance surcharge over the next few years—from $140 billion in 2001 to $170 billion in 2006. In 2001 alone, this surcharge amounted to nearly 12 percent of all income tax revenue collected.

In addition to the tax surcharge, the tax complexity due to the size and instability of the tax code creates two other types of economic costs—costs not measured in this testimony, but significant enough to keep in mind. One is the overhead cost associated with the economically sterile exercise of tax planning, compliance and litigation. The second cost results from the economic opportunities that are foregone because of taxpayer uncertainty.

In conclusion, the benefits of reducing the tax complexity burden would dramatically benefit lower income taxpayers since they bear a disproportionate amount of the burden. In essence, taxpayers could enjoy a tax reduction via tax simplification—at zero cost to the U.S. Treasury. This could be done under a comprehensive revision of the tax code guided by established tax principles, such as those supported by the Tax Foundation. In addition, such tax reform would diminish the need for corrective tax legislation in the future and thereby increase the stability in the tax code and regulations.

Methodology

The federal income tax compliance cost estimate is based on data from the Internal Revenue Service. Table 3 compiles a list of the core individual income tax forms along with both the estimated paperwork-burden calculation (in hours of compliance time) generated by the Internal Revenue Service. It also reports IRS projections for 2001 of the number of tax returns by type. Table 4 compiles a similar list for the business sector. These lists are far from exhaustive. Not only are many obscure forms and schedules left out, but the lists are also incomplete to the degree that adequate tax return information could not be obtained or estimated for the many schedules and forms that are common auxiliary components of the core forms.

One trend in tax filing has been the growth in alternative methods of filing—the tele-file and the e-file. These filing methods primarily affect the delivery of the tax filings rather than the filings themselves. In the case of the tele-file, the 1040EZ must be used in order to file over the phone. As such, all tele-filed forms were counted under the 1040EZ form. In the case of the e-file, both the 1040 and 1040A forms can be filed electronically. Unfortunately, no data is available to break down the types of e-filings. In order to keep the time estimates on the conservative side, all e-files were counted as 1040 filings (as the 1040 requires less time to file than the 1040A).

Once the total number of hours spent on compliance has been determined, an hourly rate is then applied in order to determine the cost of compliance. This hourly rate was determined in one of two ways.

First, for individuals who filed themselves, the report uses their hourly compensation rate (wages and salary plus benefits) as a proxy for their "tax surcharge." Some may argue that individuals would value their time more highly than their hourly salary rate since it is their leisure time (time not spent in formal work) that is given up to file taxes. However, to avoid speculation, we believe that the hourly compensation rate represents the best estimate of a minimum compliance cost level for individuals.

Utilizing data from the National Compensation Survey and Employment Cost Index published by the Bureau of Labor Statistics, the Tax Foundation estimates a national hourly wage and salary rate of $16.22. In addition, utilizing data from the National Income and Product Accounts published by the Bureau of Economic Analysis, the Tax Foundation estimates that benefits increase total compensation by 18.4 percent, for a total hourly compensation rate of $19.20.

Second, for filings made by tax professionals, the report uses the average compensation rate for tax accountants. Unfortunately, the National Compensation Survey does not list "tax accountants" as a separate occupation. Therefore, the Tax Foundation estimates their rate by averaging "accountants and auditors" and "lawyers" together—since tax accountants must be adept not only in accounting procedures, but also in interpreting tax law and court rulings. This yields an hourly wage and salary rate of $29.27. After adjusting this wage to include benefits, a final hourly compensation rate of $34.66 is reached.

To derive the final average compensation cost for individual filings, the report also takes into account the number of forms prepared by individuals and those prepared by tax professionals. The latest IRS data shows that 56 percent of all forms are prepared by tax professionals. Using a weighted average, the final compensation cost is $24.14. For businesses, the average compensation cost is the rate derived for the average tax accountant—$34.66.

The compensation cost was initially derived for 1999. In order to project the compensation cost out to 2006, the cost was conservatively scaled up by the estimated rate of inflation as published by the Congressional Budget Office. The projections for the number of forms filed by type were taken from the Internal Revenue Service's own estimates. The hourly estimates for the projections were taken from the 2000 forms and held static throughout the projected time-span—as such, recent policy changes are not incorporated into the hourly form estimate.

The income distribution of income tax compliance costs is the result of an allocation model developed by the Tax Foundation utilizing data published by the Internal Revenue Service—Individual Income Tax Returns, 1998. Utilizing this data, the model allocates every IRS form examined in the compliance study by income cohort.

Chairman HOUGHTON. Thank you very much, Mr. Moody. Mr. Steuerle and Mr. Gale, we just have to suspend for a moment. We will be back as soon as this vote is over. Thank you.

[Recess.]

Chairman HOUGHTON. OK. Gentlemen, thank you very much for your patience. We would like to continue the hearing. Mr. Steuerle, if you would like to give your testimony, we would appreciate it.

STATEMENT OF C. EUGENE STEUERLE, SENIOR FELLOW, URBAN INSTITUTE

Mr. STEUERLE. Thank you, Mr. Chairman. It is an honor for me to be here today, in part because earlier in my career I worked extensively with this Subcommittee on tax simplification in the late '70s. So the issue is not a new one. But I am always honored to work with the Subcommittee. Its work is always well respected, although often little recognized as well.

Ever the bridesmaid, simplification seems never to get the attention it deserves no matter which political party is in power. It would be a mistake, however, to fault elected officials for pursuing broader agendas. Government does not exist to simplify itself. It is entirely appropriate for policy to be the handmaiden to broader budget and economic policy. Nonetheless, almost everyone would agree that simplicity has been given far too little weight in the legislative process, leading to substantial waste and taxpayer cynicism.

In my oral remarks I will focus only on certain parts of my written testimony: the importance of reforming processes if simplification is to be attained, and how simplification may offer an ideal way to give direction to what otherwise could be a rather chaotic tax process over the coming months and years.

While some complexity in the tax law is inevitable at its heart, excessive complexity is a failure of process. This process failure could be mitigated by the adoption of certain executive branch and congressional procedures that would grant simplicity a higher priority. I give several examples in my testimony: Upgrading the biennial report for the study of the overall state of the Federal tax system and publishing it annually much as the Congressional Budget Office used to publish potential expenditure cuts and tax increases to deal with the deficit problem; improving the requirement under the government Performance and Results Act 1993 for Treasury to apply a performance plan to the many programs listed in the tax expenditure budget; encouraging IRS to make much greater effort to analyze the programs under its control and take greater responsibility for reporting on their success or failure; giving simplification greater weight in the legislative process by continually providing some witnesses who focus solely on simplification; requiring IRS to produce mock tax forms before passage of final legislation; and give higher status to the Joint Committee's tax complexity analysis.

Despite the trend toward increased complexity, significant tax simplification has a good chance of being passed some time in the near future. I remain an optimist. The first Secretary of the Treasury, Alexander Hamilton, had it right. "The truth is," he asserted, "in human affairs there is no good, pure and unmixed; every advantage has two sides." So, let me argue, does every disadvantage. The seed that could sprout into major simplification is in one of the worst failures of the recent legislation: the extraordinary growth scheduled in the number of taxpayers subject to the AMT. But follow the scenario out a little bit. As millions of taxpayers get added to the AMT rolls every year, public ire will be aroused over perceived unfair treatment. Americans do not take kindly to the notion that their dependents or forced payments are taxes to State and local governments or tax shelters. Accordingly, something will be done to fix the AMT despite all the difficulty.

At issue, though, is what type of bill will contain it. A large AMT fix by itself would mainly lower taxes for those with incomes still well above the average. Previous Presidents and Congress have shied away from any bill that could cater only to higher income groups. Any politically feasible AMT fix therefore probably also has to do something for taxpayers in other income classes. But AMT reform isn't a natural fit, say, with offering deductions for the middle class. The most logical way to help those less well off at the same time would be through across-the-board simplification.

Moreover, there is another issue at stake: gaining control of the agenda. There are going to be a lot of tax proposals that this Subcommittee and the fuller Committee are going to have to deal with in the near future. Simplification offers some chance of channeling this momentum, limiting the amount of special interest legislation, and keeping the focus on the attainment of a more efficient tax system. If Hamilton could see a national blessing in a national debt, then surely some modern President, Secretary of the Treasury or congressional leader will recognize that rising tax complexity itself presents an opportunity to advance tax simplification legislation before taxpayers rebel.

In sum, process reforms can accord simplicity more weight in the legislative process, in Treasury analysis and in IRS research. And the mandate for AMT relief could catalyze a much broader attack on the complexity of the tax system for all taxpayers, from poor to rich. As a practical matter simplification offers the President and congressional leaders a focus that could channel what could otherwise become a more chaotic tax policy process into an effort producing significant efficiency gains for the American economy. Thank you.

[The prepared statement of Mr. Steuerle follows:]

Statement of C. Eugene Steuerle*, Senior Fellow, Urban Institute

Mr. Chairman and Members of the Subcommittee:

The 2001 tax act was only one in a long series of tax laws complicating an already byzantine tax system. Ever the bridesmaid, simplification seems never to get the attention it deserves, no matter which political party is in power—mainly because broader agendas are always being pursued.

It would be a mistake, I believe, to fault elected officials for pursuing those broader agendas. That is their job. Government doesn't exist to simplify itself. It is entirely appropriate for tax policy to be the handmaiden to broader budgetary and economic policy, whether the issue is rate reduction in 2001 or deficit reduction in 1993. Moreover, simplification is merely one principle among several, sometimes conflicting, principles. For example, taxing all income on an equal basis generally makes the tax more efficient and fair. But carried to an extreme, it can add to complexity.

Still, in pursuing broader objectives and balancing principles, almost everyone would agree that simplicity has been given far too little weight in the legislative process. Many items in the tax law add significant complexity with little gain in achieving any other legislative goal. Almost no one would introduce many of the provisions now in current law, if designing a code from scratch. But once there, these complexities are hard to remove.

Complexity creates waste, not merely cost. Here one must distinguish between costs that might provide benefits and those that do not. A transfer of $1 from me to you may cost me $1, but there is an offset in the $1 that you pick up. Waste—including extra time and effort—involves resources that are simply lost to everyone. Professor Joel Slemrod of the University of Michigan and the National Tax Association has concluded that for each $100 of tax collected, we spend about $10 in time, effort, and administrative costs. Another cost, although more subtle, is taxpayers' resentment from filling out an unreasonable number of forms. Needless tax complexity increases their cynicism toward government and frustrates a healthy relationship between a citizenry and its government.

---

* Senior Fellow, The Urban Institute, columnist for The Financial Times and Tax Notes Magazine, and First Vice-President, National Tax Association. Portions of this testimony were first discussed in Tax Notes and the Financial Times. Any opinions expressed herein are solely the author's and should not be attributed to any of the organizations with which he is associated.

My testimony will concentrate on four items. First, I will give two examples from recent legislation of how complexity arises. Second, I will suggest ways that I believe that the process can be reformed to give greater weight to simplification. Third, I will argue that simplification could unify and give direction to tax policy efforts in the near future. Furthermore, I will show how the inevitable need to deal with the Alternative Minimum Tax (AMT) could trigger simplification reform. And, finally, I will list some of the items that should be addressed when reform comes. The last list is not comprehensive, and many of the issues are covered elsewhere, including the recent Joint Committee report on simplification.

Two Examples of How Complexity Arises in the Tax Process

Example 1: Excessive Complexity in the Refundable Child Credit. During the legislative process leading to the 2001 tax cut, a number of members of Congress and private groups sought relief for those with incomes too low to pay income tax. The result was a provision that allowed the new child credit to be partially refundable, along with the retention of an alternative method of calculating a refundable child credit for taxpayers with more than two children. But combining this new credit with the refundable earned income tax credit (EITC), while retaining an alternative child credit, adds whole layers of complexity to a tax system for low- and moderate-income Americans that is already among the most complex possible.

If Congress wants to channel refundable dollars to this portion of the population, three options could achieve roughly the same distributional and revenue effects:

- Simplest of all, adjust the EITC—in particular, by slowing down the rate at which the credit phases out, which for many taxpayers effectively adds a 21 percent tax rate on additional earnings;
- Next most simple, add on the new refundable child credit but remove the older, scarcely used and exceedingly complex, form of the refundable child credit that applies to households with more than two children; and
- Not so simple, add a new refundable child credit, but give taxpayers the option of the alternative child credit if they have more than two children, and add these two child credit calculations to the EITC calculation already required.

Almost all analysts and students of tax policy, conservative or liberal, Republican or Democrat, agree that the first option would work best and the second would be the next most preferable. Congress, nonetheless, chose the third, most complex, option. Bad intentions weren't at play, but simplicity didn't receive its due in the bargaining process. Here were the logical steps that led to the final result:

- First, the President and leaders of Congress wanted to prevent the tax bill from being overwhelmed with additional provisions. They sought to limit amendments only to the main items put forward by the President (e.g., rate relief, the child credit, marriage penalty relief). They interpreted this process rule to mean that major amendments to the EITC, other than marriage penalty relief, were not allowed.
- Second, substantial dollars were being offered in the form of a child credit. Many thought it would be easier to explain that low-income households got some portion of the new child credit rather than that taxable households got the child credit but that others got a slower phase out of the EITC. In fact, the EITC is close to a child credit in design, although its phase-in and phase-out schedules would have to be adjusted to achieve roughly the same net result.
- Third, the spirit of the tax bill was one of "creating no losers." Every tax break was to be a reduction in rates or an additional credit or deduction patched onto the existing system—no one would face additional tax. Hence, Congress decided also to keep an old child credit for those with more than two dependents to cover the few cases where that calculation might yield a higher credit than the new refundable child credit.

Note that each of the first two goals—to circumscribe what would be considered in the bill and to grant some share of new credits to lower-income individuals—is perfectly reasonable when considered by itself. The problem is that simplicity was not given much weight in the process; no one had strong authority to come forward with easier ways to pursue the goals. The third objective—creating no losers anywhere—almost guarantees that systems will grow more complex since new options are not allowed to supersede older ones.

Example 2: The Alternative Minimum Tax. The alternative minimum tax (AMT) problem keeps growing in size, not because anyone really likes it, but rather, because no one wants to bear the cost of addressing it. If you will allow me to generalize, Republicans would be glad to get rid of the AMT or have a skeletal representation. But, historically, given a choice between lower statutory rates and fixing the AMT, they will choose lower statutory rates. Democrats, of course, would be glad to have some AMT fix also. They simply don't want to give away any more money to those in the upper-income brackets or to pay for it by giving up other tax breaks that they favor too. Given a choice between a bill with an AMT fix and a less progressive distribution of taxes and one without an AMT fix and more progressivity, so far they have chosen the latter.

In a sense, both political parties get what they want: the Republicans get some of the statutory rate cuts they want and the Democrats maintain some of the progressivity they seek. The AMT provides the funding to do both. This is how it's been for a long time now; the recent tax bill is only the latest act in the drama. The current tax bill gave tax cuts with one hand (mainly statutory rate reduction) and then took some of them back with the other (the AMT). But this wasn't the first time, and everyone plays the game.

What's going to end the game? With or without a broader agenda on which to hang the AMT reform, it's going to require movement beyond current positions. For some, it will mean accepting a somewhat less progressive system. For others, it will require accepting higher statutory rates. Once again, progressivity and lower rates are both legitimate goals or principles. Simplification is simply going to have to be given more weight when choices among competing principles are made.

Process Reforms

Out of the thousands that could be cited, the two examples just presented imply that while some complexity in tax law is inevitable, at its heart, excessive complexity is a failure of process. This process failure could be mitigated by the adoption of certain Executive Branch and Congressional procedures that would grant simplicity a higher priority in the policy process. More fiduciary-like responsibility needs to be assessed and formalized in specific ways. Below, I list two types of process reforms: (1) those that would involve periodic reporting on existing law; and (2) those that would apply to new legislation. Of course, in the end, what makes any process work is the good will of the parties involved to see that its spirit is maintained.

Periodic Reports

- My first suggestion is that the biennial requirement for a study of the overall state of the federal tax system (if funded by the Appropriations Committee) should be upgraded in status. It should be published every year much as the Congressional Budget Office used to publish potential expenditure cuts and tax increases to deal with the deficit problem. The list should receive continual updates, and options over time should be spelled out in greater detail and variety. By raising the status of such a list, tax simplification is liable to get the greater attention it deserves, year after year.
- The Government Performance and Results Act of 1993 requires a performance plan review that has been extended on an embryonic basis to Treasury's tax expenditure budget. Treasury has made some very tentative steps here, though officials complain about the lack of data. While it would be foolish to think that Treasury could study each of these programs adequately each year—Congress continually mandates studies without providing the resources to back up the mandate—a cycle could be established so that each would be reviewed periodically.

  At the same time, I believe there is a fundamental failure in the IRS administrative structure that leads to Treasury's complaints about inadequate information and, indirectly, to some of IRS' internal management problems. That defect is IRS' failure to partially organize itself by program. Currently, IRS organizes itself by tax return category or type of taxpayer, not by the programs under its administration. It prepares few analyses of these programs and takes no responsibility for their success or failure because of its excessive focus upon itself only as a tax collector. Only indirectly do we find out about these programs, as when IRS measures error rates by line item on returns. It is not surprising, then, that IRS almost always ends up behind the 8-ball when Congress suddenly decides to examine the effectiveness of, say, the Earned Income Tax Credit, the tax exclusion for employer-provided health insurance, or the compliance costs imposed upon charities.

  IRS sometimes excuses itself by saying that it is in charge of administration, whereas Treasury and the White House set policy. I have some sympathy with this argument, but it is weak. No one can properly administer a program without understanding how target efficient it is and analyzing the costs of administration for both the government and its customers. IRS does not have to make any judgment on the policy itself—just on who gets the benefits, the costs of administration, and error rates (both underclaims and overclaims). In effect, it has responsibility for better development and dissemination of the information it acquires in administering the programs.

IRS is also scared to put out reports on administrative effectiveness. In reporting on the EITC during the 1990s, for instance, it knows that both former President Bush and President Clinton favored an increase in the grants made under this program. It's not going to make the political mistake of rushing out a report on problems associated with the 2001 tax rebate. And so on. Unless a regular reporting schedule is mandated, IRS will fear that the timing of any report release will appear to be politically motivated by one side or the other.

Reporting on New Legislation

Here, in turn, are some methods for giving simplicity greater weight in the legislative process:

- Testimony on proposed bills should always include at least some witnesses who focus solely on the simplification and administration issues. Although affected persons should be invited, some witnesses should be more impartial and not represent stakeholders.
- When the markup of a bill occurs, one individual at the witness table should have the sole assignment of providing information on the administrative aspects of the bill. This individual might be from the IRS, the Treasury's Office of Tax Policy, or the Joint Committee on Taxation.
- Before going to conference, the IRS should produce mock tax forms showing exactly what has been wrought from bills produced in both houses. Changes in number of users of forms and line items should also be provided, when possible.
- In conference committee, one person at the witness table should be held responsible for providing information only on the simplification aspects of the bills from both chambers of Congress.
- The Joint Committee is required to provide a "Tax Law Complexity Analysis" after reports on bills are filed. This assessment somehow needs to be given higher status in the legislative process itself. One option might be to devote one day of hearings to this type of analysis near to completion of a tax bill.

In sum, if simplification is important, then processes must be set up to insure that it is given attention and that needed resources are devoted to tracing potential and actual failures. I am hopeful that this subcommittee will devote some attention to these process efforts and not merely concentrate on items worthy of reform.

Of course, no process reform guarantees that simplification will occur. Nor, as I noted in my opening remarks, should simplification be the only factor under consideration. Nonetheless, a combination of some, if not all, of these procedures could help deter new sources of unnecessary complexity and spur the types of simplifications this subcommittee seeks.

Momentum for a Simplification Bill

Despite the trend toward increased complexity, significant tax simplification has a good chance of being passed sometime in the near future. The first Secretary of the Treasury, Alexander Hamilton, had it right. "The truth is," he asserted, "in human affairs there is no good, pure and unmixed; every advantage has two sides." So, let me argue, does every disadvantage. The seed that could sprout into major simplification is in one of the worst failures of the recent legislation: the extraordinary growth scheduled in the number of taxpayers subject to the Alternative Minimum Tax (AMT).

Under the AMT, a taxpayer calculates a separate tax on a different and narrower tax base than the regular income tax. He or she then pays the higher of the two. The AMT grows much faster than the regular tax because its exemption levels grow more slowly. Meanwhile, the new tax cut will make it more likely still that the AMT will be higher than regular tax. Thus, millions of taxpayers will get a far smaller tax cut than they anticipate. The AMT basically cancels out many of the benefits of the new lower rates in the regular income tax.

According to the Joint Committee on Taxation, the number of taxpayers subject to the AMT will grow from 1.4 million today to 5.3 million in 2004 to 19.6 million in 2006 to 35.5 million in 2010. Moreover, the revenues to be paid under that tax are also scheduled to grow into tens of billions of dollars. What puts more and more taxpayers under the AMT are not the "tax shelters" it was designed to expose but such simple items as dependent exemptions and state and local tax deductions, which the AMT doesn't allow.

For the immediate future, rude surprises are inevitable for taxpayers expecting palpable relief. And help is not on the way. With the decline in revenues as the 2001 tax legislation is phased in, and the increase in spending on national defense, drug benefits for the elderly, and new and expanded educational programs, not a lot is left over to pay for simplification.

But lets play this scenario out a bit. As millions of taxpayers get added to the AMT roles every year, the level of protest is going to rise quite rapidly. Nothing arouses public ire more than perceived unfair treatment, and Americans don't take kindly to the notion that their dependents and forced payments of taxes to state and local governments are tax shelters. Take my word for it: something will be done to fix the AMT despite all the difficulty.

At issue, though, is what type of tax bill will contain it. A large AMT fix by itself would mainly lower taxes for those with incomes above $70,000, still well above the average income. Previous Presidents, including Bill Clinton and the senior George Bush, as well as both Democratic and Republican Congresses, have shied away from any bill that would cater only to higher income groups. Even the 2001 legislation was pitched as applying to taxpayers in all income classes.

Any politically feasible AMT fix probably also has to do something for taxpayers in middle and lower income classes. But AMT reform isn't a natural fit with, say, expanding welfare benefits or offering special deductions for the middle class. The most logical—perhaps the only logical— way to help the less well off too would be across-the-board simplification.

Congress and the President are going to have to simplify taxes one way or the other. Moreover, there's another issue at stake: gaining control over the agenda. There are going to be a lot of tax proposals put forward in the near future. Simplification offers the President, as well as Congressional leaders, some chance of channeling this momentum, limiting the amount of special interest tax legislation, and keeping the focus on the attainment of a more efficient tax system.

Smart politicians will see personal opportunity in taking a lead and setting the agenda. If Hamilton could see a "national blessing" in a national debt, then surely some modern President, Secretary of the Treasury, or Congressional leader will recognize that rising tax complexity itself presents an opportunity to advance tax-simplification legislation before taxpayers rebel.

IV. A Few Candidates for Reform

In addition to the alternative minimum tax noted above, among the many sources of needless complexity today are the following:

- Phase-out after phase-out of such allowances as earned income tax credits, eligibility for IRAs, eligibility for other saving incentives, eligibility for educational tax breaks, as well as the itemized deductions and personal exemptions temporarily dealt with in the 2001 legislation. Each of these phases-outs operates like an additional mini-tax system all to itself.
- Pension and saving incentives that add administrative costs and possibly even reduce net saving by providing different rules for withdrawals, penalties, Social Security tax treatment, allowable amounts of exclusion or deduction, and so on.
- A tax treatment of dependent children that needlessly makes millions of Americans file unnecessary tax returns;
- A capital gains tax law calibrated by 7 different tax rates and requiring taxpayers to fill out pages of forms even when they have only a few dollars of gains;
- A multiple choice system of taxation of mutual fund gains, as opposed to a single system whereby mutual funds could accurately report total gains from all transactions (not just gross sales) to their account holders and to IRS;
- Multiple educational tax breaks that are poorly coordinated with each other and with direct educational expenditures, thus requiring duplicate administration and complexity for students, parents, educators, and the IRS;
- Complicated rules for charitable deductions and charities, including multiple limits on giving as a percentage of income and a perverse excise tax on foundations that actually discourages charitable giving;
- Child credits and dependent exemptions that could easily be folded into one, and, even more appropriately, folded into the earned income tax credit (EITC), and
- Unnecessarily strict estimated tax rules that pick up very little extra revenue for all the complexity they introduce.

Conclusion

Simplification is achievable if given enough attention and effort. Process reforms can accord simplicity more weight in the legislative process, in Treasury analysis, and in IRS research. The good news in all this bad news is that the tax system has now become so complicated that almost any new legislation can make taxes simpler on balance. And the mandate for AMT relief could catalyze a much broader attack on the complexity of the tax system for all taxpayers, from poor to rich. As a practical matter, simplification offers the President and Congressional leaders a focus that could channel what could otherwise become a more chaotic tax policy process into an effort producing significant efficiency gains for the American economy.

Chairman HOUGHTON. Thank you very much. Mr. Gale.

STATEMENT OF WILLIAM G. GALE, JOSEPH A. PECHMAN FELLOW, BROOKINGS INSTITUTION

Mr. GALE. Thank you very much, Mr. Chairman. I appreciate the opportunity to be here this afternoon, and I want to emphasize that I think the attention given to tax simplification is a welcome development.

I would like to structure my comments around what I view as the fundamental paradox of tax simplification, and that is, on the one hand, probably the only single thing about tax policy that everyone agrees on is that the tax system is too complicated. On the other hand, every year the tax system gets more complicated rather than less complicated. I think this paradox needs to be kept in mind in all tax simplification discussions, and I think it motivates several questions and answers regarding why taxes are complex and how we might make taxes simpler.

So let's start with the first question. If everyone thinks taxes should be simpler, why are taxes so complicated? Gene has pointed to process reasons. I want to point to policy reasons, and that is taxes are complicated because policy makers run into tradeoffs between simplifying taxes and other policy goals.

For example, the simplest tax would be an equal lump sum tax on each person, a single dollar amount per year. We don't have a tax like that and no other country has a tax like that. When England had a tax like that it created riots and it was repealed. Rather, all countries tailor tax burdens to the characteristics of individual taxpayers. Why? Because it is thought to be fairer. Well, it may in fact make taxes more fair, but it also makes them more complicated. It requires tracing consumption or income from the business sector to the individual, it requires reporting and documenting individual characteristics such as marital status, number of dependents, age, the composition of expenditures, the composition of income, et cetera. But if we want to impose taxes on an individual basis, we are stuck with some additional complexity compared to imposing an equal lump sum tax per person. So in essence policy outcomes balance one goal again the other and simplicity often comes up short in those outcomes.

This leads me to two implications for thinking about tax complexity. The first is that the fundamental question is not how complicated the tax system is. Rather the question is are we getting good value for the complications that are out there. That is, some complications are probably worth the cost and some complications aren't. In that regard you might think of tax complexity as like air pollution. It is an unfortunate, undesirable consequence of other things that we happen to like as a society. Just as we couldn't get rid of all pollution because that would mean we couldn't produce many of the things we would actually like, it is also not realistic to think that we can get rid of all tax complications. Nevertheless, just as we look for the most efficient ways to make the world cleaner, we should also look for the most efficient or fair way to simplify taxes.

The other issue to think about is that the factors that generate complicated tax systems, which are these policy tradeoffs and politics and taxpayers' desire to cut their own taxes, are not features of specific tax policies per se. If we went to a flat tax or sales tax or any other system, those features would be part of the landscape and therefore the scope for simplification I think in a realistic sense is limited by these policy tradeoffs. I would caution you to be very skeptical of claims that some other tax system which has never existed, never been tried anywhere in the world, would actually turn out to be very simple. Unless you can repeal politics at the same time you repeal the Tax Code, you are likely to end up with a very complicated tax system in one way or another.

My testimony outlines the various ways that the recent tax bill makes taxes more complicated. I won't harp on that here except to mention that the new tax law also made it more difficult to simplify taxes in the coming years precisely because it uses so much of the revenue from the projected budget surpluses for other purposes. So I view the recent Tax Act as not just a missed opportunity to simplify the tax system but a tax law that actually made the system worse and made the prospects for simplifying even more difficult.

As you think about simplifying the tax system I would suggest two principles: One is to make fewer distinctions across economic activities and personal characteristics. This would suggest that taxes be imposed on a broad base at relatively low rates that don't vary by income source or expenditure type or person type. It should be embodied in the rate structure and the tax base, not in the design of specific provisions. The other principle I think, especially in light of the recent Tax Act, is that revenue neutral tax simplification not only can but should now be undertaken, and I would add that simplification that is revenue neutral and distributionally neutral would likely be the most compelling.

In terms of specific reforms, my proposal outlines a variety of them. They are not that different from the JCT proposals. I do want to emphasize the possibility that filing and recordkeeping could be enhanced by consideration of return free tax systems and/or by significantly raising the standard deduction. The last thing I would like to toss out on a more speculative note is that, for a lot of these simplification ideas, we just don't know if they work or not. If Congress would take, say, one-half of 1 percent of all tax cuts and devote those revenues to tax simplification experiments to find out which proposals work, which proposals don't, how to design a provision to make it simpler, I think that could actually reap very large policy dividends.

Thank you very much.

[The prepared statement of Mr. Gale follows:]

Statement of William G. Gale, Ph.D., Joseph A. Pechman Fellow, Brookings Institution

My analysis of tax simplification has been influenced by discussions and collaborative research with Len Burman, Janet Holtzblatt and Joel Slemrod. The views expressed are the author's and should not be ascribed to other researchers, or to the trustees, officers, or staff of the Brookings Institution.

Mr. Chairman and Members of the Committee:

Thank you for providing me with the opportunity to present my views on issues and options related to simplification of the tax code. My testimony is divided into two sections. The first provides a summary of my principal conclusions; the second provides the economic analysis that supports these views.

Summary

Basic issues

- Although everyone thinks that the tax system should be simpler, almost every year taxes becomes more complex. This suggests that pleas for simplification need to be buttressed by an understanding of the causes of complexity and the likely outcome of simplification efforts.
- Simpler taxes have numerous benefits. They would reduce taxpayers' of complying with the tax system in terms of time, money, and mental anguish. They would likely raise the use of tax subsidies—say, for education—and reduce tax evasion. And they would likely let people see the tax system as fairer.
- But the fundamental question is *not* the overall level of complexity; rather it is whether particular tax provisions, tax systems (or alternative means of providing government services, such as spending or regulations) provide good value for the complexity they create. This depends on the magnitude and incidence of the costs and *benefits* of complexity, where the benefits include the extent to which complexity aids in achieving other policy goals.
- The factors that generate complex tax systems—policy trade-offs, politics, and taxpayers' desire to reduce their own tax burdens—are not features of tax policies per se. They will likely remain in force even if the tax system were reformed or replaced. As a result, an analysis of the extent to which policy changes can affect tax complexity should incorporate these factors.

Simplification and EGTRRA

- The new tax law provided a few simplifying measures (with respect to the EITC, the repeal of limitations on itemized deductions and personal exemptions, and the reduction in marginal tax rates).
- On net, however, the new law made taxes much more complex and made tax planning much more difficult. This is a result of the "sunset" provisions, the long and variable phase-ins and abrupt phase-outs of numerous provisions, the failure to address the long-term AMT problem, complicated provisions regarding the estate tax, and an increase in targeted subsidies in education and retirement saving.
- The new law also reduced future prospects for simplification because it allocated such a large share of projected budget surpluses toward other uses.

Simplifying the existing system

- The key to tax simplification is to make fewer distinctions across economic activities and personal characteristics. Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type. Progressivity should be embodied in the rate structure and the tax base, not in the design of specific provisions. Universal exemptions, deductions, or credits are much simpler than targeted ones.
- The following types of reforms could make taxes simpler as well as fairer and more conducive to economic growth: addressing the uncertainty created by sunset and phase-out provisions of EGTRRA; reforming the individual AMT; eliminating (or at least coordinating) phase-outs of tax credits; coordinating and consolidating provisions with similar purposes (including retirement saving and education); reducing the top tax rates in conjunction taxing capital gains as ordinary income.
- Filing and recordkeeping could be enhanced by consideration of "return-free" tax systems, and by significantly raising the standard deduction.

Complexity in the current system

- Reliable estimates of the costs of compliance, administration, and enforcement of the income tax vary widely, due in part to inadequate data. The best estimate is that, in 1995, those costs ranged between $75 billion and $130 billion, or between 10 and 17 percent of revenues. These costs are distributed mainly to taxpayers in higher income groups.
- There is wide disagreement on the compliance costs of the estate tax, but the most reliable estimates place those costs at about 10 percent of revenues.

Complexity and fundamental tax reform

- Some have turned to new tax systems—such as a flat tax or a national retail sales tax—as an alternative way to simplify taxes. These taxes are extremely on paper. But a crucial caveat is that no country has successfully enacted or administered a high-rate national retail sales tax or a flat tax. Tax systems that exist in the real world have been forged through a combination of revenue requirements, political pressures, responses to taxpayer avoidance and evasion, lobbying, and other processes that any operating tax system would eventually have to face. Notably, all of these factors tend to raise complexity. In contrast, tax systems that exist only on paper—such as the NRST and the flat tax—appear to simpler in significant part because they have not had to face real world tests yet.

Conclusion

- Tax simplification is a long-standing issue that garners widespread support, at least in principle, and is technically feasible. But the fact that most existing taxes turn out to be far more complex than most proposed alternatives should serve as a caveat to the view that achieving tax simplification, in the existing or a new tax system, will prove easy or durable.

I. Tax Complexity: Some basics (1)

A. Measuring complexity

Tax complexity has many dimensions and could plausibly be defined in different ways.

Following Slemrod (1984), we define the complexity of a tax system as the sum of compliance costs—which are incurred directly by individuals and businesses—and administrative costs—which are incurred by government. Compliance costs include the time taxpayers spend preparing and filing tax forms, learning about the law, and maintaining recordkeeping for tax purposes.(2)

The costs also include expenditures of time and money by taxpayers to avoid or evade taxes, to have their taxes prepared by others, and to respond to audits, as well as any costs imposed on any third-parties, such as employers. Administrative costs, although incurred by government, are ultimately borne by individuals. These costs include the budget of the tax collection agency, and the tax-related budgets of other agencies that help administer tax programs.(3)

Defining complexity as the total resource cost provides a quantitative measure by which different tax systems can be compared, and by which the administrative aspects of a particular tax system can be evaluated relative to its impacts on equity, efficiency, and revenue. But the definition is not ideal. Slemrod (1989a) points out that a particular subsidy could be so complicated that few taxpayers use it. If it were simplified, and enough additional people used the subsidy, total resource costs would rise, even though the subsidy itself had become less complicated.

A number of issues arise in efforts to measure tax complexity: First, permanent and transitory costs may differ. A new tax provision may raise compliance costs temporarily, as people learn about the change, even if it reduces costs in the long-term. Likewise, for administrative costs, the capital cost of upgrading IRS computers might appear as a current-year budget expenditure rather than being amortized over time. Second, only the *incremental* costs due to taxes should be included. Even with no taxes, firms would need to keep track of income and expenses to calculate profits, and individuals would engage in financial planning. This activity should be omitted from compliance cost measures. Third, an analysis of *tax* complexity alone may generate misleading conclusions. Governments can impose policies via taxes, spending, regulations, or mandates. Any tax provision can be made simpler by eliminating it, but if it then is recreated as a spending program, the overall complexity of government may rise.

B. Benefits of simpler taxes

Simpler taxes would be beneficial in a number of ways. First, simpler taxes would reduce taxpayers' of complying with the tax system in terms of time, money, and mental anguish. By reducing these costs, simplification would reduce the overall burden of taxation.

---

[1] Slemrod and Yitzhaki (2000) provide an excellent summary and analysis of issues relating to tax avoidance, evasion, and administration.

[2] These items constitute the costs measured by the Paperwork Reduction Act of 1980 and printed in the instructions for federal tax forms.

[3] For example, the Department of Labor certifies employers as eligible for the Work Opportunity Tax Credit and the Welfare-to-Work Tax Credit.

Second, tax provisions that are simpler are more likely to be used. Provisions aimed at encouraging certain activities—such as saving for college—will be less likely to be used and hence less effective if people cannot understand how they work.

Third, making taxes simpler would probably raise compliance rates (i.e., reduce illegal tax evasion). To some (uncertain) extent, people do not pay taxes because they do not understand the tax law. Clarifying and simplifying tax rules can only help to make people understand the law better, and would likely make it easier to enforce tax law as well. Evidence also suggests that people are more likely to evade taxes that they consider unfair. People who can not understand tax rules may also question the fairness of the tax system and feel that others are reaping more benefits than they are, and thus prove more likely to evade taxes.

Finally, simpler taxes would generate more public support and thus should be an essential part of any effort to improve the delivery of government services. The biggest complaint about the tax system for many people is not the amount of taxes they pay but rather the sheer, and seemingly needless, complexity of what appear to be everyday tax situations (Graetz 1997).

C. Which features of the tax code generate complexity?

The level of complexity can be influenced by structural elements—such as the tax base, the tax rate structure, and the allowable deductions, exemptions, and credits—as well as by administrative features of the tax code. The three most discussed tax bases are income, wages, and consumption. Holding the other features of the tax system constant, income is the most difficult of the three bases to tax. Income may be decomposed into its sources—wages and capital income—or its uses—consumption and saving. For a wide variety of measurement and timing reasons, it is generally easier to tax wages than capital, and easier to tax consumption than saving.

Tax rates are typically either graduated, like the current income tax, or flat, like the payroll tax. Flat-rate taxes can have lower compliance costs than graduated taxes. The presence of graduated rates gives taxpayers incentives to avoid taxes by shifting income over time or across people. And flat-rate taxes allow more efficient administrative structures to function. Taxes imposed at flat rates can be easily collected at source, since the rate does not vary across taxpayers.

Exemptions, deductions or credits that are universal create little complexity. However, targeted provisions require clear definitions of eligible taxpayers and activities, and can create compliance headaches. Finally, different ways of administering taxes may affect complexity. For example, withholding taxes at source or eliminating the requirement to file a tax return could reduce compliance costs for individuals.(4)

The discussion above suggests that, other things equal, the simplest system would tax consumption at a flat rate with universal deductions, credits or exemptions, and with withholding at source. Yet, the U.S. and many other countries tax income on a graduated basis, with numerous targeted credits and deductions, and with withholding at source only for certain types of income. Given the prevalence of these alternative systems, and absence of any country that taxes only in the simplest way described above, it is instructive to ask why existing systems deviate so strongly from the simplest structure.

D. Why are taxes complex?

Any plea for simpler taxes has to start by addressing a basic problem: If everyone thinks taxes should be simple, why are taxes so complicated? At least four factors help explain why taxes become complicated and suggest keys to making taxes simpler.

The first, and most important, is conflict among the consensus goals of tax policy. Although almost everyone agrees that taxes should be simple, most people also agree that taxes should be fair, conducive to economic prosperity, and enforceable. Even if all parties agree on these goals, they do not typically agree on the relative importance of each goal. As a result, policy outcomes usually represent efforts to balance one or more goals against the others. That is, sometimes a certain amount of complexity is created or permitted in order to help achieve other policy goals. For example, attempts to make taxes fairer often conflict with attempts to make taxes simpler. Most countries tailor tax burdens to the characteristics of individual taxpayers. This may improve tax equity, but it also creates complexity. It requires tracing income or consumption from the business sector to the individual. It requires reporting and documenting individual characteristics such as marital status, number of dependents, and age, as well as the composition of expenditures or income.

[4] However, as we discuss below, some of those costs may be shifted to employers, other businesses, or government agencies.

It allows tax rates that vary with individual characteristics, creating opportunities for tax avoidance.

In this context, tax complexity is like air pollution: it is an unfortunate and undesirable consequence of products or services that we, as a society, desire. Just as the optimal level or air pollution is not zero—since that would mean that many of the goods and services society cherishes could not be produced—the optimal level of tax complexity is not zero. And just as we should seek the most efficient ways to reduce air pollution, we should also seek the most effective ways to make taxes simpler.

The second factor that generates tax complexity is the political process. Politicians and interest groups have interests in targeted subsidies that reduce taxes for particular groups or activities. But targeted subsidies inevitably make taxes more complex by creating more distinctions among taxpayers and among sources and uses of income.

Third, some complexity is necessary to deter tax avoidance. Taxpayers have every right to reduce their taxes by any legal means. But this activity inevitably raises questions about whether particular activities or expenditures qualify for tax-preferred status. The Treasury Department responds with complex rules designed to limit avoidance. Taxpayers in turn respond by inventing complex transactions to skirt the new rules. This can create a vicious cycle that leads to more and more complex rules and increasingly sophisticated and complex avoidance strategies.

Fourth, many complicated provisions were enacted to raise revenue or limit revenue losses during times of rampant budget deficits. For example, the landmark Tax Reform Act of 1986 (TRA)—a remarkable accomplishment in many respects—fell short of its goal of simplicity to meet the requirement of "revenue neutrality." TRA created several complicated phase-outs and hidden taxes in order to raise revenue and meet distributional targets. Insofar as complexity has arisen from efforts to limit revenue loss, the surplus that existed at the beginning of this year and the political consensus in favor of some sort of tax cuts created an opportunity to simplify taxes. In that regard, and as discussed further below, the recent tax act is not only a missed opportunity for simplification, but may also have used up whatever funds would otherwise have been available to support simplification efforts.

E. Implications for thinking about tax simplification

Recognition of these factors has several important implications for the study of tax complexity.

- First, the fundamental question is *not* the overall level of complexity, but whether particular tax provisions, tax systems (or alternative means of providing government services, such as spending or regulations) provide good value for the complexity they create. This depends on the magnitude and incidence of the costs and *benefits* of complexity, where the benefits include the extent to which complexity aids in achieving other policy goals.
- Second, the factors that generate complex tax systems—policy trade-offs, politics, and taxpayers' desire to reduce their own tax burdens—are not features of tax policies per se. They will likely remain in force even if the tax system were reformed or replaced. As a result, an analysis of the extent to which policy changes can affect tax complexity should incorporate these factors.
- Third, there is an important distinction between private and social gains or costs. Suppose everyone had to fill out five extra lines of the tax form to receive a $1,000 tax cut. Each person might regard that as "good complexity," worth the cost of providing extra information. But, holding tax revenues constant, the revenue would still have to be raised from somewhere, so the net tax cut would be zero—that is, everyone's tax "cut" would be from a higher initial tax liability and net taxes would be the same. Thus, from a social perspective, the sum of all individuals' "good complexity" could be zero or negative.

II. Simplification and the new tax law

A. Provisions

The Economic Growth and Tax Relief Recovery Act (EGTRRA) was signed into law by President Bush on June 7, 2001.

Both the most important and most novel aspect of EGTRRA is the general provision that the entire bill "sunsets" at the end of 2010. All provisions of the bill are eliminated and the tax code at that point reverts to what it would have been had the tax bill never been passed.

The act also contains numerous specific provisions. Some of these are listed in table 1 and described here along with their effective phase-in and phase-out dates. They are listed in order of the tax cut provided when fully phased in.

- Reduce marginal income tax rates of 28 percent or higher:

The 28, 31, and 36 percent tax rates (which apply to married households with taxable income above $45,200, $109,250, and $166,500, respectively) will each fall by 3 percentage points, and the 39.6 percent top rate (which applies to married households with taxable income above $297,350) will fall to 35 percent. Each of these rates declines by 1 percentage point as of July 1, 2001, a second point in 2004, and the reductions are completed in 2006.

- Eliminate the estate tax:

The effective exemption in the estate tax is raised from $675,000 currently to $1 million in 2002, and then gradually to $3.5 million in 2009. The top effective marginal tax rate is reduced from 60 percent currently to 50 percent in 2002 and then gradually to 45 percent in 2009. The credit for state-level estate taxes is gradually phased out between 2002 and 2005, after which it is replaced by a deduction. This change finances about one-quarter of the cost of the entire reduction in federal estate taxes. In 2010, the estate and generation-skipping transfer taxes are repealed, the highest gift tax rate is set equal to the top individual income tax rate, and the step-up in basis for inherited assets that have capital gains is repealed.

- Create a new 10 percent income tax bracket:

A new tax bracket of 10 percent is carved out of the first $6,000 of taxable income for singles, and the first $12,000 of taxable income for married couples. This income is currently taxed at a 15 percent rate. Starting in 2002, the 10 percent bracket is implemented by changing the tax rate and withholding schedules. In 2001, the 10 percent bracket is implemented by providing an advance credit for 2001 taxes. The advance credit is a one-time payment of the minimum of the taxpayer's 2000 income tax payment (the payment due on April 15, 2001) or $300 ($600) for singles (married couples). This payment is intended to substitute for the 10 percent tax bracket in 2001, but for some taxpayers it will serve more as a rebate of the previous years' taxes because taxpayers who do not owe taxes in 2001 but did owe them in 2000 will not have to repay the rebate they receive.

- Increase and expand the child credit:

The child credit is gradually increased, from $500 currently to $1,000 by 2010. The child credit is also made refundable to the extent of 10 percent of a taxpayers earned income above $10,000 for 2001–4 and 15 percent for subsequent years, with the $10,000 amount indexed for inflation. Refundability improves the access to, and amount of, child credit benefits for low-earning households.

- Partially address the marriage penalty:

The standard deduction for married couples gradually rises from 174 percent to 200 percent of the standard deduction for singles in the years 2005 to 2009. The top income level in the 15 percent bracket for married couples gradually rises from 180 percent to 200 percent of the similar level for singles from 2005 to 2008. The beginning and ending of the EITC phase-out will gradually increase by $3,000 by 2008, and will be indexed for inflation thereafter.

- Repeal of limitations on itemized deductions and phase-outs of personal exemptions:

The repeals are phased in between 2005 and 2009.

- Pension and IRA provisions

Contribution limits for Individual Retirement Accounts and Roth IRAs will rise to $5,000 by 2008 and be indexed for inflation thereafter. Contribution limits to 401(k)s and related plans will rise gradually to $15,000 in 2006 and then be indexed for inflation. Additional so-called "catch-up" contributions of up to $5,000 for anyone over the age of 50 will be permitted. Roth 401(k) plans can be established starting in 2006. A non-refundable credit for retirement saving for low-income taxpayers will be available between 2002 and 2006.

- Education provisions

Taxpayers may take an above-the-line deduction for qualified higher education expenses, but only for the years 2002 to 2005. Effective in 2002, the contribution limit on education IRAs rises to $2,000 from $500. The definition of qualified expenses from education IRAs is expanded. Pre-paid tuition programs will now benefit from tax-free withdrawals as long as the funds are used for education. Deductions for student loans are made more generous.

• Temporarily, limited AMT relief

Between 2001 and 2004, the exemption amount in the individual AMT is increased by $2,000 for single taxpayers and $4,000 for married taxpayers. This provision is abolished at the end of 2004.

B. Effects of EGTRRA on tax complexity

It would be an understatement to say that simplification was not one of the goals of EGTRRA. In fact, the overall net impact of the new tax law will be to make taxes more complicated over time.

There are three bright spots for simplification. First, for the earned income credit, the bill simplifies the definition of earned income, the definition of a qualifying child, and calculation of the credit. This is an important set of changes since it allows benefits to be provided to low-income households in a manner that is easier to understand.

Second, the bill repeals the limitations on itemized deductions and the phase-out of personal exemptions will simplify taxes for high-income taxpayers. These provisions are hidden taxes that serve no purpose that could not be generated by rate adjustments. In fact, the repeal was implemented in exchange for a smaller reduction in marginal tax rates for the highest income taxpayers than would otherwise occur. This trade-off—giving up explicit rate reductions in exchange for provisions that simplify the tax system—could provide a useful model for dealing with the problems created by the alternative minimum tax in the future.

Third, the reduction in income tax rates will indirectly help to simplify tax planning.

Increasing the number of tax brackets does not generally make compliance more difficult; taxpayers will continue to look up their tax liability in a tax table. But lower tax rates simplify tax compliance indirectly by reducing the incentive to avoid taxes or find tax shelters.

Despite these changes, however, the overwhelming net effect of the bill will be to make tax filing and tax planning more complex.

(1) Complexity due to increased uncertainty: Sunsets and phase-outs

As noted above, the most novel feature of the bill is the sunsetting of all provisions as of December 31, 2010. In addition, various features of the bill phase-in and phase-out at different times. Taken at face value, these provisions make tax planning more complex, since the tax rules will be changing on a near constant basis, giving taxpayers incentives to shift the level, form and timing of their income and deductions. The good news is that few people take the sunset provisions at face value. The bad news, though, is that not taking them at face value makes tax planning even more complex, since it is not yet known what will replace the sunset and phase-out provisions, or when such provisions will be altered. The prevailing sentiment may be best summed up by Washington Post columnist Al Crenshaw (2001) who noted that "The new tax law doesn't make planning unnecessary, it just makes it impossible."

While sunsets and phase-outs create planning difficulties for any situation, they appear to have particularly egregious effects in at least two areas: estate planning and pension choices. Taxpayers may end up having to make their wills and estate plans contingent on the year in which they die, because the provisions are legislated to change so massively on a year-to-year basis. For pensions, a key goal is to raise employer sponsorship of plans. But employers will naturally be reluctant to incur the fixed costs of creating new plans and educating their employees about the plan, if there is a chance that the plan, or the particular provisions that made the plan worth offering, may not be in existence after a few years.

(2) Complexity due to increased number of choices

Complex rules or documentation procedures are a common source of tax complexity. However, a new and increasing source of complexity might be termed "choice" complexity. This occurs when taxpayers are given numerous subsidies but may only use one or a few of them. This type of complexity has proliferated with regard to retirement saving, where taxpayers have been able to choose to allocate contributions among traditional, Roth, and education IRAs for several years. Under the tax bill, they will soon be able to choose to allocate 401(k) contributions between traditional and Roth plans as well. Similar issues apply to the variety of education subsidies that exist today, and which were expanded in EGTRRA.

In economic models that feature fully informed consumers who make choices without incurring transactions costs, having more options is always preferable to having fewer options. However, in designing tax policy it is not necessarily the case that more options are always worth the added costs. First, the differences in benefits to a household between choosing one of a set of options versus another in the same set may be smaller than the costs of determining which the best option. But of course the household does not know that until it has undertaken the cost. Second, having more choices, for example with respect to retirement saving, requires more record-keeping by the taxpayer and the government.

(3) Alternative minimum tax

The AMT is a parallel tax system that was created to prevent high-income taxpayers from aggressively using tax shelters and deductions to eliminate their tax burdens. Taxpayers must calculate the AMT if their regular income tax liability is less than their AMT liability. The AMT is quite complex and requires tax filers to make many detailed calculations. Currently, fewer than 2 million taxpayers face the AMT.

There are (at least) two "AMT problems" facing the tax code currently. The first is that, even without the new tax law, the number of taxpayers facing the AMT is scheduled to rise to about 20 million by 2011. This occurs primarily because the AMT exemption amounts are not indexed for inflation. In addition, the overwhelming reason why these taxpayers will end up facing the AMT is that the personal exemptions and state tax deductions that they take in the regular income tax are not allowed in the AMT. Thus, the AMT will increasingly be capturing more people, and from the perspective of curtailing tax sheltering, the wrong people over time. While the new tax law does not make this problem worse, it does not do anything to fix it, either.

The second problem is created by the new tax law. By 2010, when the law is fully phased in, JCT estimates that about 35 million taxpayers will face the AMT. This occurs because the tax law reduces regular income tax but not (in years after 2004) AMT.

The bill offers only temporary, partial relief against the AMT, but that provision sunsets after four years. As a result, any gains in simplicity arising from lower income tax rates would be offset several times over after 2004 because lower rates would subject millions of taxpayers to the individual alternative minimum tax.

(4) The estate tax

Abolition of the estate tax sounds, on the surface, like a simplifying measure, but in the tax bill it is not. The bill stipulates three stages for estate taxes: from 2002 to 2009, the tax is modified in many ways. In 2010, the estate tax is abolished and step-up in asset value for inherited assets is repealed. In 2011, the estate tax is reinstated, as is the step-up in asset value for inherited assets.

This creates several sources of complexity. The first is the sunset provision, as noted above. The second is the transition period before the estate tax is abolished. The estate tax phase-out is slow and involves several changes between now and 2009: the exemptions are raised, the tax rates are reduced, the credit for state taxes is abolished and replaced with a deduction, and gift tax limits are dramatically changed. Both the sunset and the transition make effective estate planning quite complex between 2002 and 2011.

The third issue is the repeal of basis step-up at death. Under current law, when an heir receives an asset from an estate, the basis price is "stepped up" The new bill features "basis carryover:" heirs inherit an asset's original basis price. Implementing carryover raises vexing issues. For example, some families would have to keep records for generations to keep track of asset purchase prices and improvements. Carryover basis would raise taxes on many heirs compared with current law unless modest gains are excluded from the new rule. But exempting a portion of capital gains would create a great deal of complexity. For example, under current law, it is easy for a parent to split an estate equally among his or her children. Under basis carryover, the estate would have to decide how to allocate a capital gain exclusion among the children. The assets inherited by children who received equal bequests, but different exclusion amounts, would be worth different amounts on an after-tax basis. A carryover basis provision was enacted in the late 1970s, but was repealed before it took effect because taxpayers complained about the new complexities and problems in implementation. There is no reason to think these issues would be any easier to deal with now.

(5) Expansion of targeted subsidies (mainly in education and retirement saving)

Targeted subsidies complicate taxes. Each program require precise definitions of eligible taxpayers, income levels, and qualifying expenses. Many of the proposed incentives would require separate worksheets or tax forms. The possibility of honest mistakes or fraud would rise commensurately. The government would need to spend more on monitoring or auditing taxpayers, and the programs would likely send more lower—and middle-income households to paid tax preparers. The main culprits along these lines in the tax bill are the education subsidies. As one example, one provision of the bill will let people buy computers, educational software, and internet access for their school-age children with tax-preferred funds.

C. Effects of EGTRRA on prospects for tax simplification

Besides directly complicating the tax code, EGTRRA has substantially dimmed prospects for tax simplification in the future, because the tax act allocates revenues that could otherwise have been used for simplification.

Significant tax simplification almost has to be associated with net tax cuts. The Tax Reform Act of 1986, for example, substantially simplified individual income taxes but also cut the revenue collected from such taxes. The overall act was deemed revenue-neutral because net taxes collected at the corporate level were slated to increase.

Simplification has proven difficult in the past because eliminating loopholes and preferences in a revenue-neutral package of individual income tax changes means that taxes on some people and some activities will rise, while taxes on others will fall. This naturally raises difficult political issues. Achieving simplification in a tax cut package, however, could avoid the politically difficult offsetting revenue increases, giving everyone lower and simpler taxes.

D. Effects of new tax proposals on complexity

In the aftermath of EGTRRA, the Ways and Means Committee has approved HR 7, which among other things would allow households who do not itemize their deductions to take an above-the-line deduction for charitable contributions. Perhaps the most notable feature of this proposal is the tiny contribution limits involved: the provision would allow for up to $25 per person for this deduction in 2002, rising to $100 per person in 2010.

This proposal could simplify matters for the 2 percent of taxpayers who currently itemize, but whose deductions other than charity are less than the standard deduction. But for the roughly 70 percent of taxpayers who take the standard deduction, the change would add complexity. They would need to keep records of contributions, which might be difficult if the contributions are small or in cash. A similar deduction in the early 1980s created serious compliance problems, with many taxpayers claiming undocumented deductions. Both the cap on non-itemized charitable deductions and the interaction of this provision with the phase-out of itemized deductions for high-income taxpayers would complicate choices for some taxpayers and require more auditing and monitoring by the IRS. It is hard to see how the complexity engendered by these provisions would be worth the costs, and lawmakers might consider simply raising the standard deduction instead of providing an above-the-line deduction for charitable giving.

III. Simplifying the existing tax system

Despite the setback that EGTRRA represents for actual and prospective simplification efforts, there are a number of options available to policy makers who are interested in simplifying the existing tax system.

A. Principles

The key to tax simplification is to make fewer distinctions across economic activities and personal characteristics. Taxes should be imposed on a broad base at relatively low rates that do not vary by income source or expenditure type. Progressivity should be embodied in the rate structure and the tax base, not in the design of specific provisions. Universal exemptions, deductions, or credits are much simpler than targeted ones. Broadening the base by eliminating targeted preferences and taxing capital gains as ordinary income directly removes major sources of complexity. Using the revenue raised to increase standard deductions removes people from the tax system, and using the revenue to reduce tax rates reduces the value of sheltering and cheating. Increasing the number of people that face the same "basic" rate facilitates withholding of taxes at the source, which further simplifies taxes and raises compliance. In short, broadening the base and reducing the rates, which in general may be considered efficiency-enhancing, would also simplify taxes (see Pechman 1990, Slemrod 1996, Slemrod and Bakija 1996, Gale 1997, 1998).

Slemrod (1996) refers to such plans as "populist simplification." That is, they make taxes simpler for a large number of taxpayers, but the overall saving in compliance costs may not be very large. Not all structural reforms, of course, have the same impact on compliance costs. Slemrod (1989b) found no significant saving from changing to a single-rate tax structure. In contrast, eliminating the system of itemized deductions would result in a substantial reduction in expenditures on professional assistance; the impact on total compliance costs, though, varied depending on the model used.

B. Specific Reforms

The following reforms could make taxes simpler as well as fairer and more conducive to economic growth.

Address the Uncertainty Created by Sunset and Phase-out Provisions of EGTRRA The most urgent simplification need is to clean up the tax planning problems, complexities and uncertainties created by EGTRRA with regard to seemingly capricious phase-in and phase-outs of provisions and the sunsetting of the entire bill. Either the provisions should be made permanent or they should be abolished. Having numerous tax provisions dangle for an indefinite period does not simplify the tax code. (On a related note, it would also make sense to decide whether to keep permanently or to abolish the entire set of temporary tax provisions that existed even before EGTRRA.)

Reform the Individual AMT To spare middle-income people who were never its target, the AMT should be indexed for inflation, deductions should be allowed for dependents and state and local taxes, and all personal credits should be available against the AMT. Any proposal that cuts regular income tax liabilities should be required to make conforming adjustments to the AMT so that more taxpayers are not subjected to the alternative tax. Some would argue that the AMT should be eliminated altogether. But a reformed AMT would prevent the very wealthy from eliminating their tax liability, and legislators will probably want to be spared the embarrassment of seeing how successfully the well-advised can exploit loopholes.

Eliminate (or at least Co-ordinate) Credit Phase-Outs A number of credits phase out across different income ranges. Each credit requires separate worksheets and tax calculations. The phase-outs create hidden taxes over the phase-out range, and diminish the effectiveness of the credits in encouraging the activities they are designed to spur.

Coordinate and Consolidate Provisions with Similar Purposes In a number of areas, numerous provisions—each with slightly different rules—apply to the same general activity. Coordinating or consolidating the following provisions would simplify taxes, often with little or no forgone revenue:

• *EITC, Dependent Exemption and Child Credit* Several recent proposals would combine features of the tax code that deal with families with children. Coordinating the three tax subsidies—and adopting a common definition of "qualifying child"—could make taxes much simpler for low-income households.

• *Education Subsidies* Choosing among the alternative tax subsidies for college education requires college algebra and a lawyer's attention to detail. These choices could be made far simpler through consolidation into two subsidies, one focusing on saving incentives for education, and one on either deductions or credits for current educational expenditures.

• *Saving Incentives* Independent of employer-provided accounts, households may save in Individual Retirement Accounts (IRAs), Roth IRAs, educational IRAs, and Keogh plans. Rules concerning contribution limits and withdrawal patterns vary by program. Consolidating these options into one or two non-overlapping options with simple and broad rules on eligibility, contribution, and withdrawal rules would simplify tax planning for retirement.

• *Capital Gains* Capital gains will eventually be taxed at up to eleven different rates, depending on the asset, the owner's income, when the asset was purchased, and how long it was held. It would be much simpler to replace this confusing hodge podge with an exclusion of a set fraction of capital gains from taxable income—say 50 percent—as was done prior to 1987.

Reduce the top tax rates and tax capital gains as ordinary income This was the cornerstone of the deal struck in 1986 that allowed substantial simplification of the individual income tax. It would massively reduce incentives to shelter funds and the need to engage in complex tax planning.

C. Simplify Filing and Record-Keeping

Thirty-six countries administer some sort of "return-free" tax system. Under such a system, the taxpayer or the taxpayer's employer supplies a few information items to the tax authorities, which calculates the tax due and bills the taxpayer. Up to 52 million taxpayers (and many more if the standard deduction were significantly increased) could be placed on a return-free system with relatively minor changes in the structure of the income tax. These include filers who have income only from wages, pensions, Social Security, interest, dividends, and unemployment compensation; who do not itemize deductions or claim credits other than the EITC or the child credit; and who are in the zero or 15 percent tax bracket (Gale and Holtzblatt 1997).

Nevertheless, the net cost savings may not be great. Over 80 percent of the affected taxpayers currently file the relatively simple 1040A and 1040EZ returns and the others file 1040s but have relatively simple returns. Taxpayers subject to a return-free system would still have to provide information to tax authorities on a regular basis. Some administrative costs would merely be shifted from taxpayers to employers, other payers, and the IRS. And if state income taxes were not similarly altered, many taxpayers would still need to calculate almost all of the information currently needed on the federal return.[5]

Another way to reduce the costs of filing and record-keeping would be to expand the standard deduction significantly. This would curb administrative costs by reducing the number of households that itemize their deductions. It would also provide a tax cut for many low- to middle-income households. Estimates suggest that if the number of personal exemptions each household was granted were reduced by one and the standard deduction was raised by $4,000, the number of itemizers would fall by one-third, revenues would be maintained, and progressivity would be enhanced (Aaron and Gale 1996).

D. Procedural changes

Procedural changes in the tax policy process might indirectly help to simplify taxes by raising the visibility and explicit consideration of simplicity and enforcement issues. For example, the recent IRS restructuring legislation requires the IRS to report to Congress each year regarding sources of complexity in the administration of Federal taxes. The Joint Committee on Taxation (JCT) is required to prepare complexity analysis of new legislation that impacts individuals or small businesses.

Another way to increase the visibility of simplification issues is for the Treasury or a Congressional agency to release an annual list of simplification proposals. A Treasury "blue book" released in 1997 contained over 50 proposals for simplification, two of which were enacted later that year. The IRS restructuring act requires the JCT to include simplification proposals in biennial reports on the state of the Federal tax system.

E. Fund simplification experiments

Finally, a serious commitment to tax simplification could be established if Congress and the Administration would devote a small amount, say 0.5 percent, of the size of any proposed tax cut to conduct experiments and trial runs to show what type of simplification taxpayers would like and how best to establish such procedures. Given the magnitude of tax cuts recently enacted, 0.5 percent would go toward funding a very large amount of new efforts to make taxes simpler.

IV. Complexity in the current tax system

A. Compliance costs in the income tax

The complexity, or total resource costs, of the current tax system can be divided into several components: the amount of time it takes individuals and businesses to comply with the tax system, the valuation of that time, the out-of-pocket costs incurred by taxpayers, and the administrative costs borne by government.

Three surveys, conducted during the 1980s and described in table 2, provide data on the time taxpayers needed to comply with federal taxes. Slemrod and Sorum (1984) surveyed 2,000 taxpayers in Minnesota in 1983. Weighting the responses to reflect national averages, they estimated that taxpayers spent 2.1 billion hours filling out their 1982 federal and state income tax returns. Blumenthal and Slemrod (1992) repeated the survey in 1990 and found that time requirements for 1989 returns had increased to 3.0 billion hours. Unlike the earlier survey, the latter survey's estimates include time spent arranging financial affairs to minimize taxes.

The largest survey, commissioned by the IRS and conducted by Arthur D. Little (ADL, 1988), asked 6,200 taxpayers by mail about time spent preparing 1983 federal income tax returns. ADL also surveyed 4,000 partnerships and corporations and their paid preparers. ADL used the results to develop models that could be used with readily available data to estimate compliance costs in future years. To develop the models, the time for each activity (e.g., learning about tax law) associated with each form was assumed to be a linear function of the number of items on the form, the number of words of instructions and references to the IRC and regulations, or the number of pages in the form. Based on these models, ADL estimated that tax-

[5] Another option is to subsidize electronic filing (Steuerle 1997). Electronic filing may help reduce error rates because returns are often prepared using computer software programs with built-in accuracy checks, and it prevents key punch errors that could otherwise occur at the IRS. The IRS restructuring act establishes a goal that 80 percent of tax returns should be filed electronically by 2007. In February 2000, the Clinton Administration proposed a temporary refundable credit for electronic filing of individual income tax returns to help achieve this goal. The proposal was not enacted in 2000.

payers spent 1.6 billion hours on 1983 individual income tax returns and 1.8 billion hours on 1985 returns. For partnerships and corporations, the estimates were 2.7 billion hours for 1983, and 3.6 billion hours for 1985.

The IRS currently uses the ADL models to estimate the time required to complete forms and schedules. These estimates are published with the tax forms as part of the "Paperwork Reduction Act Notice." For FY 1997, OMB (1998) estimates that taxpayers needed 5.3 billion hours to comply with the requirements of all tax forms and IRS regulations. This estimate applies to businesses and individuals, and includes all federal taxes, not just income taxes.

Several features of the ADL/IRS model are problematic, however. Most obviously, complexity can be related to many factors other than the number of lines or words on a form. When complexity is related to the length of instructions on the form, the ADL model may get the sign wrong. For example, if instructions were moved off of a form and into a separate publication, the ADL model would show compliance costs falling when the change may well have actually increased compliance costs. Another set of concerns focuses on the business model (Slemrod 1996). The model does not adjust its cost estimate for the scale of the business. Inexplicably, it overstates survey estimates of hours by partnerships, corporations and their preparers by a factor of four or more. And the ADL study may not be very representative; it only includes one corporation with assets in excess of $250 million, and only 9 with assets over $10 million.

Given an estimate of the number of hours individuals and businesses spend complying with the tax system, the next component of compliance cost requires placing a value on taxpayers' time. The surveys above did not inquire about this issue. Instead, analysts have generally imputed some measure of opportunity cost to individuals. Different methodologies result in widely varying estimates of the value of taxpayers' time (table 3). Vaillancourt (1986) uses the taxpayer's pre-tax wage, on the grounds that this is the cost to society. Slemrod (1996) argues that taxpayers are more likely to forgo leisure than work to complete a tax return, and so uses after-tax wages. Payne (1993) and Hall (1995, 1996) value individual and business taxpayers' time by averaging the hourly labor costs of one of the major accounting firms and the IRS. This approach undoubtedly overstates the appropriate costs for individual taxpayers. The implicit assumption that a taxpayer and tax professional operate at the same level of efficiency when completing a tax return is doubtful, and ignores the expertise the tax professional has developed. And the vast majority of taxpayers do not face tax situations anywhere near as complicated as those seen by an accountant at a major firm or an IRS examiner.

Estimates of the total resource costs of operating the income tax vary widely (table 2). Payne (1993) estimates costs of $277 billion (1995 dollars) for 1985.[6] Hall (1996) estimates costs of about $141 billion in 1995. Slemrod (1996) estimates costs of $75 billion in 1995. The differences between these estimates are driven largely by two factors: whether to use the results from the ADL business model or the business survey, and how to value the time spent by businesses and individuals. Both Payne and Hall use the results from the ADL model, which appears to overstate the relevant costs. Slemrod uses the results from the survey. Both Hall and Payne value taxpayer time at the cost of tax professionals' time, which is problematic for reasons stated above. Slemrod values taxpayers' time at the after-tax wage.

Given the existing data, it is possible to suggest a range of plausible estimates of the annual costs of operating the income tax. Slemrod's $75 billion estimate provides a realistic lower bound. An upper-bound estimate of $130 billion is obtained by adjusting Hall's estimate for the value of time (using Slemrod's estimate of $15 an hour rather than Hall's estimate of $39.60), and adding individuals' out-of-pocket expenditures ($8 billion that Slemrod and Payne include) and tax administrative costs ($5 to $7 billion).

All of these estimates are based on taxpayer surveys. However, although they may provide the best available information to date, the survey results should be interpreted with caution. All of the surveys have low response rates. They do not distinguish between permanent and transitory costs. The surveys omit compliance costs imposed on taxpayers after returns are filed (except for Payne, who provides only a rough estimate of audit costs). It is unclear whether survey respondents have netted out the cost of non-tax activities, or distinguished the costs of one tax from other taxes. In addition, the surveys were undertaken in the 1980s and are now dated. Several major and minor tax bills have become law over the last 15 to 20 years. It is not evident that the IRS methodology captures these changes. Over the

---

[6] Payne calculates a total cost of $514 billion, but about $237 billion is primarily attributable to "disincentives to production," or the excess burden caused by distortions in relative prices. These costs are generally not included in compliance estimates.

same period, technological change has generally worked to reduce compliance costs. For example, when the IRS initiated the first pilot of electronic filing in 1986, a handful of professional tax preparers electronically transmitted 25,000 returns. By 2000, over 35 million taxpayers filed electronically. In many cases, they filed from home by telephone or personal computer. The cost savings from electronic filing are not reflected in the compliance cost estimates.(7) All of these considerations suggest the need for a new, comprehensive survey of taxpayer compliance costs.

B. The distribution of tax complexity

Measures of resource costs indicate the total administrative burden of taxes, but provide no information about which taxpayers bear the biggest burdens. Just as the distribution of tax payments is central to policy discussions, the distribution of the burden of tax complexity is also worth considering.

For many taxpayers, direct contact with the income tax is relatively simple. In 1998, 17 percent of taxpayers filed the 1040EZ, a very simplified version of the standard 1040 form.(8) An additional 21 percent of taxpayers filed the 1040A. Relative to the 1040EZ, the 1040A requires more information and contains several more complicated provisions, but it is still fairly simple.(9) The remaining taxpayers filed the standard 1040 form. About 8 percent of taxpayers filed the 1040 but were eligible to file a 1040A or 1040EZ. An additional 6 percent did not itemize their deductions, did not claim capital gains or losses, and did not have business income (defined to include business net income or loss, rents, royalties, farm net income, farm rental income, partnerships, S-corporations, estates and trusts). The figures above show that in 1998, over half of taxpayers either filed a simplified form or filed the 1040 but did not itemize deductions, have business income or report net capital gains. Thus, for most taxpayers, filling out an income tax form is relatively straightforward.

Survey estimates support these findings. Blumenthal and Slemrod (1992) found that, while the average taxpayer reported spending 27.4 hours on filing income tax returns and related activities, 30 percent spent less than 5 hours, and 15 percent spent between 5 and 10 hours. At the high end, 11 percent spent 50–100 hours and 5 percent spent more than 100 hours. Out-of-pocket costs averaged $66 (in 1989 dollars), but 49 percent of filers had no such costs and another 17 percent had costs below $50. Slightly over 7 percent spent more than $200. Expenditures of time and money were highest among high-income and self-employed taxpayers.

Information on the use of paid preparers may provide additional evidence on how complex individuals find the system to be. In 1998, 53 percent of tax filers used paid preparers. Among those who filed the 1040, 64 percent used preparers. Even among 1040A and 1040EZ filers, 35 percent used preparers. At first glance, these figures suggest that most taxpayers do not believe they have simple tax situations. However, it is not entirely clear how to interpret the figures. Some individuals use preparers to obtain quicker refunds through electronic filing. Also, with relatively high income and often little leisure, many families pay others to clean their homes, plan their retirement nest egg, etc.; that they have turned to professional tax preparers as well may not provide any evidence about complexity.

C. Complexity and corporate taxes

The factors most likely to create high compliance costs for large corporations include depreciation rules, the measurement and taxation of international income, the corporate alternative minimum tax, and co-ordinating federal and state income taxes (Slemrod and Blumenthal, 1996). In addition, the largest firms are almost continually audited, and final resolution of corporation tax returns can stretch over several years. Nevertheless, the magnitude of compliance costs and the impact of tax complexity on firm operations is controversial.

---

7 The IRS web site, launched in 1996, enables taxpayers to download forms and publications and registered 968 million "hits" during the 2000 filing season.

8 To be eligible for the 1040EZ, taxpayers must be single or married filing jointly, have taxable income below $50,000, have income only from wages, salaries, tips, taxable scholarships, unemployment compensation, and interest, with taxable interest income below $400. Filers of the 1040EZ can claim personal exemptions, the standard deduction and the earned income tax credit (EITC) for workers who do not reside with children.

9 To qualify for the 1040A, taxpayers' income must come from only from wages, taxable scholarships, pensions, IRAs, unemployment compensation, social security, interest and dividends. Taxpayers may report IRA contributions, student loan interest deductions, personal exemptions, the standard deduction, the EITC, the child tax credit, the child and dependent care tax credit, education tax credits, and the credit for the elderly and disabled, and exemptions for the elderly and blind. Taxable income must be below $50,000. Some of the issues arising for 1040A filers include head of household filing status, dependency rules, child-related credits, and in rare cases the AMT.

At one end of the spectrum, company representatives have testified in Congress that it cost Mobil $10 million in 1993 to prepare its U.S. tax return, which comprised a year's worth of work for 57 people. These costs sound astonishingly high at first glance, but closer examination suggests otherwise. In 1993, Mobil operated in over 100 countries and had worldwide revenues of $65 billion and profits of about $4 billion. Mobil's revenues exceeded the GDP of 137 countries and 22 of the states in the United States. Mobil's self-reported costs of compliance were about 0.015 percent of revenues and 0.25 percent of profits. Viewed in this context, the burden imposed by compliance with the U.S. income tax appears relatively small.(10) In contrast, a recent study of the Hewlett-Packard corporation concluded that "[a] large U.S. multinational company can complete an accurate corporate tax return with the functional equivalent of three full-time tax professionals" (Seltzer 1997, p. 493). It would be interesting to know why Mobil's return required so many more resources than Hewlett-Packard's. To the extent that the problem lies in the tax system, it would be useful to know which features caused the problems.

D. Compliance costs and complexity in the estate tax

Estimates of the compliance cost of the estate tax vary enormously, partly because the methodologies are suspect. Munnell (1988) is cited as claiming that "the costs of complying with the estate tax laws are roughly the same magnitude as the revenue raised" (Joint Economic Committee 1998). But Munnell actually wrote that compliance costs "may well approach the revenue yield." Even this more modest conclusion, however, is based on a number of rough calculations and more or less informed guesses, rather than hard evidence.

Munnell noted that, at the time, the American Bar Association reported that 16,000 lawyers cited trust, probate, and estate law as their area of concentration. Valuing their time at $150,000 per year on average and assuming they spend half the time on estate taxes yields $1.2 billion in avoidance costs, compared to estate tax revenues of $7.7 billion in 1987. To get from $1.2 billion to close to $7.7 billion, Munnell refers to "accountants eager to gain an increasing share of the estate planning market," financial planners and insurance agents who devote a considerable amount of their energies to minimizing estate taxes, and the efforts of the individuals themselves, and concludes that the avoidance costs "must amount to billions of dollars annually." It is also worth noting that Munnell's estimates are now out-of-date and that estate tax revenues have risen dramatically during the intervening period. Thus, even if compliance costs at that point were almost equal to revenues, they may not be today.

Davenport and Soled (1999) estimate tax planning costs by surveying tax professionals about average charges for typical estate planning in six different estate size classes and applying these estimates to the number of returns filed in 1996. This yields estimated costs for planning of $290 million. Using fairly *ad hoc* but not implausible adjustments for such factors as the number of nontaxable decedents that do tax planning and tax planning that has to be repeated when tax laws change, they estimate planning costs of $1.047 billion in 1999. They add $628 million for estate administration costs, based on taking one-half of the total lawyers' fees and other costs reported on estate tax returns, and reducing that number by 45 percent to reflect the tax deductibility of the costs. (Note that the last reduction is inappropriate for measuring the social, rather than private, costs of the activity.) The sum of their estimates for planning and estate administration comes to $1.675 billion in 1999, or about 6.4 percent of expected receipts. They allocate another 0.6 percent of revenues for the administrative costs of IRS estate tax activities, for an estimated total cost of collection of 7.0 percent of revenues.

The Davenport-Soled (DS) estimate is more recent and more detailed than Munnell's. Although both estimates require some arbitrary assumptions, it is difficult to see how the basic DS methodology could be redone with an alternative set of reasonable assumptions to yield an estimate that avoidance costs are anywhere close to 100 percent of revenues. The estimates above are based on suppliers of estate tax avoidance techniques. Another approach would be to survey the demanders of the service, the wealth owners. This approach has been employed with some success for the U.S. individual income tax (Slemrod and Sorum 1984, Blumenthal and Slemrod 1992), and the corporation income tax (Blumenthal and Slemrod 1996). As a point of comparison, based on such studies, Slemrod (1996) concludes that collection costs for the U.S. individual and corporate income tax is about 10 percent of the revenue collected.

[10] In the same year, Mobil paid $19 million in U.S. income taxes and its total world-wide tax burden was $1.931 billion.

Unfortunately, no reliable and comprehensive survey research has been carried out for the estate tax. What does exist applies only to businesses, and may be considered suspect. Astrachan and Aronoff (1995) surveyed businesses in the distribution, sale, and service of construction, mining, and forestry equipment industry, and separately surveyed businesses owned by African-Americans. Each of these are very special and small subsamples of the estate tax population, and the methodology employed is worrisome on a number of dimensions. For example, the authors include as a cost of avoidance the amount spent on insurance premiums to provide liquidity for paying the estate tax. This expense is properly thought of as pre-paying the tax liability, and to consider it as a cost in addition to the tax liability itself is surely inappropriate double counting.

Astrachan and Tutterow (1996) survey 983 family businesses in a variety of industries and find that family business owners have average expenditures of over $33,000 on accountants, attorneys, and financial planners working on estate planning issues; family members averaged about 167 hours spent on estate planning issues over the previous six years (the timeframe for the dollar expenditures is not made clear). However, these estimates include life insurance fees that represent prepayment of estate tax liabilities. In addition, an unknown fraction of the costs is due to estate planning, *inter alia* about intergenerational succession of the business, that is unrelated to taxation. Repetti (2000), while corroborating in surveys of estate tax attorneys the broad magnitude of the Astrachan and Tutterow results, argues that a significant portion of these costs would be incurred even in the absence of estate taxes.

In sum, there is some evidence on the costs of estate planning for small businesses, but the estimates are marked by conceptual problems and disagreement about the fraction of costs due to the estate and gift tax as opposed to non-tax factors or other taxes. For the broader population, there is no informative evidence from surveys of wealth owners.

V. Simplification and the national retail sales tax

A national retail sales tax has been proposed recently by Congressmen Dan Schaefer (R–CO) and Billy Tauzin (R–LA) and by a group called Americans for Fair Taxation (AFT).[11] The sales tax base would include almost all goods or services purchased in the United States by households for consumption purposes. The imputed value of financial intermediation services would also be taxed.[12] To tax households' consumption of goods and services provided by government, all federal, state, and local government outlays would be subject to federal sales tax. The tax would exempt expenditures abroad, half of foreign travel expenditures by U.S. citizens, state sales tax, college tuition (on the grounds that it is an investment), and food produced and consumed on farms (for administrative reasons).[13]

The sales tax would provide a demogrant to each household equal to the sales tax rate times the poverty guideline, the annual income level below which a family of a given size is considered in poverty. States would collect the sales tax, and businesses and states would be reimbursed for tax collection efforts. The IRS would monitor tax collection for businesses with retail sales in numerous states.

The required tax rate in a national retail sales tax merits attention. Tax rates can be described in two ways. For example, suppose a good costs $100, not including taxes, and there is a $30 sales tax placed on the item. The "tax-exclusive" rate is 30 percent, since the tax is 30 percent of the selling price, excluding the tax. This rate is calculated as T/P, where T is the total tax payment and P is the pre-sales-tax price. The "tax-inclusive" rate would be about 23 percent, since the tax is 23 percent of the total payment, including the tax. This rate is calculated as T/(P+T). Sales taxes are typically quoted in tax-exclusive rates; this corresponds to the percentage "mark-up" at the cash register. Income taxes, however, are typically quoted at tax-inclusive rates. The reported tax-inclusive rate will always be lower than the tax-exclusive rate and the difference rises as tax rates rise.

The AFT proposal assumes a 23 percent tax-inclusive rate (30 percent tax-exclusive). The Schaefer-Tauzin proposal assumes a 15 percent tax-inclusive rate (17.6 percent tax-exclusive). The difference in rates in the two proposals is due to the different taxes slated for abolition. Both proposals would abolish taxes on individual income, corporate income and estates. The AFT would also eliminate payroll taxes,

[11] See H.R. 2001, "The National Retail Sales Tax Act of 1997."

[12] For example, households purchase banking services through reduced interest rates on their checking account, and the value of these implicit payments would be included in the tax base.

[13] Retail sales occur when a business sells to a household. Thus, purchases of newly constructed housing by owner-occupants would be taxable, but resales of existing homes would not be.

which raise considerable sums currently, while the Schaefer-Tauzin proposal would eliminate excise taxes, which raise little revenue.

The actual required rates would be much higher, however, for several reasons (Gale 1999). First, the plans stipulate that government must pay sales tax to itself on its own purchases but fail to allow for an increase in the real cost of maintaining government services. Fixing this problem alone raises the required rate in the AFT proposal to 35 percent on a tax-inclusive basis and 54 percent on a tax-exclusive basis (Gale 1999). Second, the plans do not allow for any avoidance or evasion, though it is universally acknowledged that both will occur. Third, the plans propose to tax an extremely broad measure of consumption, but political and administrative factors would very likely require a narrower base. Conservative adjustments for these factors raise the required tax-inclusive rate to 48 percent and the tax-exclusive rate to 94 percent in the AFT proposal, and 35 percent and 54 percent, respectively, in the Schaefer-Tauzin proposal (Gale 1999). Related analysis by the Joint Committee on Taxation (2000) reaches similar conclusions.

A. Sources of complexity

As a flat-rate consumption tax with a universal demogrant, the sales tax contains many of the features that generate simpler taxes. In principle at least, the simplicity gains could be impressive. Most individuals would no longer need to keep tax records, know the tax law, or file returns. The number of taxpayers who would have to file would decline significantly, and would include only those sole proprietorships, partnerships, and S—and C-corporations that made retail sales. The complexity of filing a return would decline dramatically as well.

Nevertheless, a NRST could create new areas of complexity. The demogrant is based on the HHS poverty guidelines, which rise less than proportionally with the number of family members. For example, in 1998, the poverty level was $8,050 for a single individual, plus $2,800 for each additional family member. Thus, the poverty level for a family of four was $16,450, just over twice the level for an individual. This structure will create incentives in many households for citizens to try to claim the demogrant as individuals rather than families. It is also not obvious from AFT descriptions how the demogrants would be administered, or even which agencies would be responsible for determining eligibility and monitoring taxpayers. Thus, the compliance and administrative costs of ensuring that the appropriate demogrant is paid could be significant.

Another area of potential complexity stems from tax avoidance and evasion behavior. The primary way to avoid sales taxes would be to combine business activity with personal consumption. For example, individuals may seek to register as firms, individuals may seek to purchase their own consumption goods using a business certificate, and employers might buy goods for their workers in lieu of wage compensation (GAO 1998). Ensuring that all business purchases are not taxed and all consumer purchases are taxed would require record-keeping by all businesses, even though only retailers would have to remit taxes in a pure retail sales tax. The AFT proposal deviates from a pure retail sales tax by requiring that taxes be paid on many input purchases and that vendors file explicit claims to receive rebates on their business purchases. This would raise compliance costs further.

A second source of tax avoidance and evasion concerns the importation of goods and services from abroad. Imported purchases of up to $2,000 per year per taxpayer would be exempt from the sales tax. This feature is likely to be exploited fully by many taxpayers, not because they travel abroad but because it would be very simple for firms to set up off-shore affiliates, warehouses, or mail order houses and ship goods to domestic customers. Moreover, it would be very difficult to monitor such arrangements and it seems quite likely that taxpayers could end up importing more than $2,000 per person on a tax-exempt basis. Some related evidence on the potential extent of these problems comes from the experience with state-level "use" taxes under which taxpayers voluntarily make tax payments on goods purchased in other states. Enforcement of such taxes has been "dismal at best" (Murray, 1997). The development of electronic commerce could raise many additional avoidance and evasion problems for the sales tax.

B. Compliance cost estimates

There are no rigorous estimates of the compliance and administrative costs associated with a high-rate NRST. Some evidence is available with respect to state sales taxes. Slemrod and Bakija (1996) report that administrative costs were between 0.4 and 1.0 percent of sales tax revenues in a sample of 8 states, and compliance costs were between 2.0–3.8 percent of revenues in 7 states. Hall (1996) cites a Price-Waterhouse study that found that retailers spent $4.4 billion complying with state retail sales taxes in 1990. Adjusting for increased retail sales between 1990 and

1995, he asserts an NRST with no demogrant would have administrative costs of $4.9 billion.[14]

Unfortunately, as Slemrod and Bakija (1996) note, compliance cost estimates from state sales taxes are likely to vastly understate the analogous costs in a NRST for several reasons. First, at 4 and 6 percent, state sales tax rates are an order of magnitude lower than the required rate in a NRST. The higher rates in an NRST would encourage more taxpayers to engage in time-consuming taxpayer avoidance and evasion activities than under the existing state sales taxes, and this, in turn, would increase the required tax rate and compliance and administrative costs. Second, state sales tax bases are very different from the proposed federal base. States sales taxes typically include a significant amount of business purchases (Ring 1999). This reduces compliance costs, since distinguishing business and retail sales is costly. To avoid taxing business in a NRST may require all businesses to file returns and receive rebates, which would raise costs. State sales taxes often exclude hard-to-tax sectors. All states exempt financial services from their retail sales taxes, but the NRST would not. Third, states do not provide demogrants.

On the other hand, states often exempt from taxation goods such as food, housing, rent, and health care, for political or social reasons. This increases compliance costs relative to taxing a broader base because defining the boundaries of the exemption (for example, distinguishing "food" and "candy") can be difficult, and record keeping requirements can be extensive. However, if a NRST required high rates, there would be massive political pressure to exempt goods like food, health care, and rent.

C. Other sales taxes

To address administrative problems and other concerns with the retail sales tax, many countries have employed value-added taxes (VATs). VATs are paid by businesses and impose taxes on all sales, including business-to-business transactions. Each business owes taxes on its sales and receives deductions or credits to account for the taxes it paid on its purchases. Controlling for administrative factors, the net economic effect of a VAT should be the same as an NRST. The key administrative advantage of a VAT over an NRST is that the existence of a paper trail can improve compliance rates. The chief disadvantage is the added compliance costs created. See Cnossen (1999) for further discussion.

Mieszkowski and Palumbo (1998) describe a "hybrid NRST" which would add the following features to a retail sales tax: (a) taxes would be due on all sales of multipurpose goods and services used as final consumption goods or business inputs, (b) businesses would file for rebates for the taxes collected on business inputs, and (c) sales taxes would be withheld at pre-retail stages of production and distribution, such that taxes collected at one stage of production and distribution are credited at the next stage.[15] This system would improve compliance relative to the NRST by developing a more extensive paper trail to identify suspicious returns and facilitate tax audits. However, the tax would also be more complex. A system of cross-checks and cross-reporting would be needed to limit fraud. The number of firms required to file would rise much closer to VAT levels than NRST levels. And businesses would file more frequently, perhaps on a bi-weekly or even weekly basis, in order to claim refunds. Mieszkowski and Palumbo concur with those who claim, as we do above, that the compliance experience of state sales tax is not very relevant for formulating cost estimates for a high-rate national sales tax. They note that the compliance costs of a hybrid NRST would likely be "several multiples" of the $20 billion compliance cost estimates they cite for an NRST. Note that if several equals "four," the costs of complying with and administering this system would be as high as Slemrod's estimated costs for the income tax.

VI. Simplification and the flat tax

Originally developed by Robert Hall and Alvin Rabushka (1983, 1995), the flat tax has been proposed in legislative form by Representative Richard Armey (R–TX) and Senator Richard Shelby (R–AL).[16] Under the flat tax, businesses would pay taxes on the difference between gross sales (including business-to-business transactions) and the sum of wages, pension contributions, and purchases from other businesses, including the cost of materials, services, and capital goods. Individuals would pay

[14] Adopting IRS time estimates of the costs of completing the schedules for interest and dividends, the child and dependent care tax credit, and the EITC, Hall estimates that adding a demogrant would cost $6.3 billion and thus raise the total cost to $11.2 billion. Hall (1996) estimated that taxpayers would spend $8.2 billion to comply with the Schaefer-Tauzin NRST. The estimate was also based on experience with state sales taxes. It does not include the compliance costs of payroll tax credits, used in the Schaefer-Tauzin plan, to rebate sales taxes.

[15] See also Gillis, Mieszkowski, and Zodrow (1996), and Zodrow (1999).

[16] See H.R. 1040 and S. 1040, "Freedom and Fairness Restoration Act of 1997."

taxes on their wages and pension disbursements, less exemptions of $21,400 for a married couple ($10,700 for single filers) and $5,000 for each dependent. Both individuals and businesses would pay the same flat tax rate, estimated by Treasury (1996) to be 20.8 percent (on a tax-inclusive basis). As with the sales tax, realistic versions of the flat tax will require higher rates. Unlike the sales tax, however, the required rate estimate for the flat tax already incorporates evasion and avoidance and does not assume that government tries to raise revenue by taxing itself. The only significant adjustments are for transition relief and the possible retention of some major deductions and credits due to political pressures. Adjusting for those factors, the required rates range between 21 percent and 32 percent (Aaron and Gale 1996).

A. Sources of complexity

As with the sales tax, the proposed flat tax would change the tax base to consumption, flatten tax rates, eliminate all deductions and credits in the tax code, and vastly simplify tax compliance. For taxpayers who were not self-employed, the individual filing requirement could probably be eliminated. For those that did have to file, the tax form could be a relatively short postcard with simple calculations. The tax would eliminate individual-level taxation of capital gains, interest and dividends and the individual AMT.

Any well-functioning business already retains records of wages, material costs and investments, so tax filing would impose little additional cost. The flat tax would eliminate the differential treatment of debt versus equity, the uniform capitalization rules, the corporate alternative minimum tax, depreciation schedules, rules regarding defining a capital good versus a current input, depletion allowances, corporate subsidies and credits, the potential to arbitrage across different accounting systems, and a host of other issues. The tax distortions currently caused by inflation would vanish.

Nevertheless, the flat tax would retain some existing sources of complexity and exacerbate others. It would also create entirely new areas of complexity, and the types of complexity it would abolish could easily creep back into the code. Some areas of the existing tax code are also common to the flat tax and would prove just as difficult as ever. These include rules regarding independent contractors versus employees, qualified dependents, tax withholding for domestic help, home office deductions, taxation of the self-employed, and non-conformity between state and federal taxes. The treatment of travel and food expenses might also cause problems. To the extent they are a cost of doing business, the expenses should be deducted in the flat tax. To the extent they are a fringe benefit, they should not. Making this determination may prove difficult. Graetz (1997) emphasizes the numerous problems in the existing system that would be retained in the flat tax.

A potentially more troubling issue is that, since the flat tax makes different distinctions than the existing system does, the flat tax will create new "pressure points," and so could create a host of *new* compliance and sheltering issues. For example, under the existing income tax, a firm must pay taxes on interest income as well as income from sales of goods. In the business portion of the flat tax, receipts from sales of goods and services are taxable, but interest income is not. This creates an important incentive in transactions between businesses subject to the flat tax and entities not subject to the business tax (households, governments, non-profits, and foreigners): the business would like to label as much cash inflow as possible as "interest income." The other party (not subject to the business tax component of the flat tax) is indifferent to such labeling. The same possibility occurs for cash outflows from businesses. Outflows that are labeled purchases of goods and services or capital investments are deductible, while outflows that are labeled interest payments are not deductible. This creates obvious incentives for businesses to label as "purchases" as much of their cash outflow as possible, and possibly seriously erode the tax base and tax revenues. Thus, while it equates the tax treatment of debt and equity flows, the flat tax creates a new wedge between inflows labeled "sales" and those labeled "interest," and a new wedge between outflows labeled "purchases" and those labeled "interest expense." Concerns that these wedges would be easily manipulated led McLure and Zodrow (1996) to conclude that the business tax "contains unacceptable opportunities for abuse."

Another new area of complexity concerns wages, fringe benefits, and current operating expenses. Under the current system, all are deductible to firms. Under the flat tax, however, fringe benefits are not deductible. Gruber and Poterba (1996) speculate that this wedge could bring back the "company doctor." In the flat tax, a firm's contribution for health insurance would not be deductible, but its payment for in-house doctors, nurses, and medical equipment would be deductible.

Some flat tax rules will exacerbate existing tax complexities. The sheltering of personal consumption, especially durable goods, through business would become more important due to the more generous deduction for expensing. Conversion of business property to individual use ought to generate taxable income for the business, but would be hard to monitor.

The tax treatment of mixed business and personal use raises a number of issues. A family who rents rooms in its home or has a vacation home must currently follow fairly complex rules for allocating expenses and depreciation between personal and rental use. The flat tax is based on cash flow, however, so it is not clear how such items would be handled. Suppose a taxpayer bought a home in year 1 and in year 5 decided to begin renting a room in the house. What deduction for the cost of the capital good would the homeowner be able to take? The answer should not be "none" since depreciation is a legitimate business expense. Nor should the answer be "expensing" since the flat tax is based on cash flow and the house did not become a business property until year 5, during which there was no house purchase. But any other answer will lead to a potentially complicated new set of rules (or the same rules that currently exist). Also, if a deduction were allowed, then the decision to stop renting the room or the vacation home after a period of time would implicitly convert a business asset to personal use and so should be taxed at the business level under the flat tax (Feld 1995).

Current law imposes limits on how taxes or losses may be allocated among different taxpayers. These provisions regarding consolidated returns, S-corporations, and partnerships stop firms from merging solely for tax purposes. They appear to have no counterpart in the proposed flat tax. However, as Feld (1995, p. 610) notes: "the logical conclusion of unregulated allocation of deductions would allow free transferability of losses. Historically, however, the outcry against the opportunity by wealthy businesses to purchases exemption from income tax has produced the existing restrictions on the transfer of loss corporations and repeal in 1982 of the finance lease provisions of the 1981 tax act." It thus seems likely that a complex set of laws would have to be imposed to stop such behavior.

Taxpayers may also create pressure to find ways to transfer income between wages and business income. Under the flat tax, business and wage incomes are recorded on separate forms. Thus, a business loss may be carried forward, but—unlike in the current system—it can not be used to offset current wage income.

The flat tax would create several incentives regarding cross-border flows. Firms would have incentives to engage in transactions that shifted interest expense offshore and interest income into the United States. Transfer pricing would probably work to encourage firms to locate more profits in the United States, since the tax rate would be lower here than in most other industrialized countries. Both of these issues would be easy to exploit and would drain revenues from foreign countries. Some sort of retaliation, adjustment or treaty negotiation might be expected, which would then require changes in the tax treatment of international flows under the flat tax (Hines 1996).

Feld (1995) highlights a variety of additional concerns with the business tax, including the role of in-kind transfers to a corporation, the definition of a business input (and the possible need to exempt passive assets from the definition), and possibly complex rules for hedging transactions to distinguish those that are part of the business from those that are investments by the individual.

Despite its apparent simplicity, the individual tax also creates some potential areas of complexity (Feld, 1995). First, the flat tax would effectively renegotiate every alimony agreement in the country. Under the flat tax and other reform proposals, alimony payments would no longer be deductible and alimony receipts would no longer be taxable. Second, suppose that Victim earns money and then Robber takes it away. Under the flat tax, Victim is still liable for taxes, and Robber is not. Under the income tax, it is the other way around. Third, prize money won by contestants would be deductible by the sponsoring organization as an expense, but does not appear to be taxable as wages. Addressing any of these problems would make the flat tax more complex.

Lastly, a new system will inevitably create unintended loopholes that will need to be addressed via corrective tax measures. It would be a mistake to underestimate the creative ingenuity of America's accountants, attorneys, and tax planners.

To be clear, all of the concerns noted above could be resolved by writing carefully detailed rules covering each contingency. But of course that is what the current system already does. There is little reason to believe that the ultimate resolution of most of these issues will be simpler under the flat tax than in the current system. Feld (1995) concludes that to avoid losing revenues, the flat tax will either generate complicated business transactions (to skirt the simple rules) or complicated tax laws (to reduce the gaming possibilities), or both. This conclusion seems quite reasonable to us.

All of the discussion above focuses on the pure flat tax. However, if the flat tax were implemented, "[w]e should expect near unanimity that it will be necessary to provide transition relief" (Pearlman, 1996). Zodrow (2000) concurs that some transitional relief is "virtually inevitable." Pearlman and Zodrow discuss the various types of transition relief that could be provided, including compensating firms for lost depreciation deductions and carry forwards of AMT credits, net operating losses and foreign tax credits. The treatment of interest deductions will also require attention. More generally, because taxes are embedded in the fabric of existing legal contracts, transitioning to a new tax system could potentially affect numerous aspects of agreements in other areas. The effect on alimony, noted above, is one such example. Pearlman concludes (p. 419) that "inevitably, any approach [to transition relief] will make the new law more complex for a long time."

Another potential source of complexity is the reintroduction of social policy into the tax code. The pure flat tax would be devoid of all social policy initiatives. Thus, the flat tax would not only change tax policy, but also reduce the generosity of subsidies toward housing, the charitable sector, family and children, education, health insurance, state and local governments, etc. For each existing deduction and credit, however, a political case would be made that the subsidy should be retained. To the extent that social policy creeps back into the flat tax, there will be added complexity. Notably, because the flat tax has an individual component—whereas the sales tax, for example, does not—social policy in the flat tax can be tailored to individual circumstances. However, credits for children, child care, and education all raise issues of eligibility, compliance and phase-outs. Retention of popular deductions would require additional record-keeping, reporting and monitoring. Retention of the mortgage interest deduction, in a system that does not tax interest income, could create arbitrage opportunities and added record-keeping costs. Corporate subsidies for research, environmental clean-up, and other goals could easily wend their way back into the business tax. And to the extent that the demand for any of these programs remained and the tax system was able to remain clean, there is a possibility that the programs would return as spending or regulatory initiatives.

A third source of complexity in a modified flat tax concerns the real and perceived distributional effects. Families in the very highest income or consumption strata would see tax burdens fall dramatically (Gale, Houser, and Scholz 1996). The flat tax would make poor families worse off, because it would eliminate the earned income tax credit, but the increased burdens on the poor would not be as large as the reduced burdens on high-income families. The difference would be made up by increased taxes on middle-class families (Dunbar and Pogue 1998; Gale, Houser and Scholz 1996; Gentry and Hubbard 1997; Mieszkowski and Palumbo, 2000).[17]

It seems unlikely that these distributional effects will pass political muster. Retaining the earned income tax credit would reduce much of the distributional loss of the pure flat tax (Gale, Houser, and Scholz 1996), but would raise compliance costs. Moving to a Bradford-style X-tax (which would use the flat tax base, but has graduated tax rates on wages and sets the business tax rate at the highest wage tax rate) would provide more progressivity, but would also create administrative and compliance problems. It would significantly increase the revenue loss from transition relief. This would require higher tax rates on the remaining tax base. It would re-introduce taxpayer incentives and attempts to redistribute income across people or over time to exploit tax rate differentials. By raising tax rates at the high end of the income distribution, it would increase political pressure to restore popular itemized deductions.

A number of issues regarding what economists might describe as perceptions of fairness also arise. For example, there will be an inexorable tendency to compare the flat tax to an income tax because both are collected from individuals and businesses. Despite the fact that taxes on capital income will be collected at the business level, the non-taxation of capital income at the individual level may upset citizens who are used to seeing people remit taxes directly to the government on the capital income they receive.[18]

---

17 Fullerton and Rogers (1996) and Metcalf (1997) show that the distributional impacts over taxpayers' lifetime are not as extreme as those on an annual basis. The relevance of this finding for political support of the flat tax, however, is debatable.

18 The flat tax would not tax the normal return to capital, only the excess return. That reduction in the effective tax rate on capital income may be a source of added controversy in the flat tax, but it is distinct from the issue addressed in the text, which concerns whether taxes on capital income are remitted by individuals or businesses.

Several perception issues arise in the business tax. Unlike the current corporate or individual business taxes, the business tax in the flat tax does not attempt to tax profits. Changing the entire logic and structure of business taxation will create several situations that will be perceived as problems by taxpayers and firms, even if they make perfect sense within the overall logic of the flat tax.

First, some businesses would face massive increases in their tax liabilities. For example, Hall and Rabushka (1995) note that General Motors' tax liability would have risen from $110 million in 1993 under the current system to $2.7 *billion* under a 19 percent flat tax. Despite economists' view that individuals-not businesses—bear the burden of taxes, there will likely be massive resistance at the business level to such changes. Businesses who oppose such change will demand reductions in the tax base or other types of relief.

Second, some businesses with large profits will pay no taxes. Profit (before federal taxes) is equal to revenue from sales and other sources less deductions for depreciation, interest payments, materials, wages, fringe benefits, payroll taxes, and state and local income and property taxes. The tax base in the business tax, however, is equal to revenue from sales minus materials, wages, pension contributions, and new investment. Thus, if a firm had large amounts of revenue from financial assets (i.e., not from sales of goods and services), it could owe no taxes or even negative taxes under the flat tax even though it reported huge profits to shareholders. This situation is consistent within the context of the flat tax. But in the past, precisely this situation led to the strengthening of the corporate and individual alternative minimum taxes, which are universally regarded as one of the most complex areas of the tax code. It is hard to see why those same pressures would not arise in the flat tax.

The third issue is the flip side of the second: some firms with low or negative profits may be forced to make very large tax payments. For example, a firm with substantial amounts of interest expense, fringe benefits, payroll taxes, and state and local income and property taxes could report negative profits, but since these items are not deductible in the flat tax, the firm could still face stiff tax liabilities. Again, this makes sense within the context of the flat tax, but will not be viewed as fair by firm owners who wonder why they have to pay taxes in years when they lose money and who will push for reforms. Misunderstanding of this point could be very important. For example, the Wall Street Journal editorial board (February 5, 1997), a strong supporter of the flat tax, nevertheless complains about a German tax that can force companies to pay taxes "even when they are losing money." The flat tax, however, would do exactly the same thing for some firms. This will lead to efforts by businesses to retain currently existing deductions for health insurance, payroll taxes and state and local income and property taxes. Taken together, these deductions would cut the business tax base by more than half.

B. Compliance cost estimates

Slemrod (1996) and Hall (1996) have attempted to quantify the compliance costs of the pure flat tax. Both authors' estimates ignore transition issues and the potential reemergence of social policy. Using the ADL model for taxpayer hours described above and valuing taxpayer time at $39.60 per hour, Hall estimates that the costs of record-keeping, learning about the tax law, form preparation, and packaging/sending would equal $8.4 billion. The projected 93 million individual returns are estimated to take an average of one hour and eight minutes. The projected 24.4 million business returns are estimated to take an average of three hours and 24 minutes to complete.

Hall's estimates seem both significantly too large in some respects and significantly too small in others. For example, valuing individuals' time at $15 per hour and business time at $25 per hour, as Slemrod does, would reduce the estimate by about half. On the other hand, some of the time estimates seem implausibly low, and possibly off by orders of magnitude. Individual taxpayers are estimated to spend an average of 2.4 *minutes* per year doing record keeping for tax purposes. Businesses are estimated to spend only 2.3 hours per year on record keeping for tax purposes. Remarkably, especially in light of the discussion above on possible areas of complexity, businesses are estimated to spend an average of only 18 minutes learning about the tax law, and 24 minutes gathering all the relevant documents and preparing the return. In addition, Hall's estimate leaves out many components of compliance costs, such as tax planning and auditing.

Slemrod concludes (1996, p. 375) that "it is impossible to confidently forecast the collection cost of the business part of the flat tax on the basis of observable systems, because none exists." Instead, he offers an educated guess that the flat tax would cut business compliance costs (which were $17 billion in the individual income tax and $20 billion in the corporate tax) by one-third, and cut individual filing costs by

70 percent (from $33 billion to $10 billion), for total compliance costs of about $35 billion. This is $35 billion less than his compliance cost estimate for the income tax, or about 0.5 percent of GDP in 1995.[19]

VII. Conclusions

As a purely technical matter, tax complexity and tax evasion can be reduced, and tax administration can be made more just and efficient. As a political and policy matter, however, making these improvements have proven quite difficult. Efforts to simplify the tax system typically run up against conflict with other tax policy goals, political factors, taxpayers' efforts to avoid and evade taxes, and revenue requirements. Each of these factors tends to shape the base, credits, deductions, rate structure and administrative aspects of the tax system in ways that raise complexity. Efforts to reduce evasion sometimes run into similar problems.

To the extent that simplicity is a goal of tax reform, many improvements could be made within the existing system. Pure versions of both the national retail sales tax and the flat tax could be vastly simpler than even an improved income tax. But realistic versions of the flat tax and especially the sales tax would require tax rates much higher than advertised by their proponents. These higher rates complicate tax compliance and enforcement. The sales tax would face potentially serious problems with enforceability and political pressure for exemptions. The flat tax would face the same political pressures, and while enforceability is not a major issue, the tax would likely become significantly more complex than currently proposed.

Thus, simplification is an important goal of tax reform, but lasting and significant simplification may prove difficult to establish. Policy makers and voters should, therefore, weigh the costs and benefits of simplification against the other goals of tax policy.

REFERENCES

Aaron, Henry J. and William G. Gale. 1997. Fundamental Tax Reform: Miracle or Mirage. In Setting *National Priorities*, edited by Robert D. Reischauer. Washington, DC: Brookings Institution Press, 235–62.

Arthur D. Little. 1988. *Development of Methodology for Estimating the Taxpayer Paperwork Burden.* Final Report to the Department of the Treasury, Internal Revenue Service. Washington, DC, June.

Astrachan, Joseph H. and Craig E. Aronoff. 1995. A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups. Unpublished paper. Kennesaw State College, Family Enterprise Center.

Astrachan, Joseph H., and Roger Tutterow. 1996. The Effect of Estate Taxes on Family Business: Survey Results. *Family Business Review* 9(3): 303–14.

Blumenthal, Marsha and Joel Slemrod. 1992. The Compliance Cost of the U.S. Individual Income Tax System. *National Tax Journal* 45(2): 185–202.

Blumenthal, Marsha and Joel Slemrod. 1996. The Income Tax Compliance Cost of Big Business. *Public Finance Quarterly* 24(4): 411–38.

Calegari, Michael. 1998. Flat Taxes and Effective Tax Planning. *National Tax Journal* 51(4): 689–713.

Cnossen, Sijbren. 1999. On the Feasibility of RST, VAT, BTT, FT, CIT. Mimeo.

Crenshaw, Albert B. 2001. Tax Planning May Be Futile, New Law Will Shift From Year to Year, Then Expire in 2011. *Washington Post* June 3, H2.

Davenport, Charles and Jay A. Soled. 1999. Enlivening the Death-Tax Death-Talk. *Tax Notes* 84(4) special report: 591–630.

Department of the Treasury. 1996. Internal Revenue Service. *Federal Tax Compliance Research: Individual Income Tax Gap Estimates* for 1985, 1988, and 1992. Internal Revenue Service Publication 1415, Revision 4–96.

Departure Tax. 1997. *Wall Street Journal* (February 5): A18.

Dunbar, Amy, and Thomas Pogue. 1998. Estimating Flat Tax Incidence and Yield: A Sensitivity Analysis. *National Tax Journal* 51(2): 303–324.

Feld, Alan. 1995. Living with the Flat Tax. *National Tax Journal* 48(4): 603–17.

Fullerton, Don and Diane Lim Rogers. 1996. Lifetime Effects of Fundamental Tax Reform. In *Economic Effects of Fundamental Tax Reform,* edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 321–352.

Gale, William G. 1997. Tax Reform is Dead, Long Live Tax Reform. Brookings Policy Brief No.12.

[19] Calegari (1998) and Weisbach (1999) make a variety of points similar to those above and extend the analysis in a number of directions in their insightful analyses of administrative issues in the flat tax.

Gale, William G. 1998. Let's Revamp the Tax Code—But How? *Wall Street Journal* (April 15), 1.

Gale, William G. 1999. The Required Tax Rate in a National Retail Sales Tax. *National Tax Journal* 52(3): 443–57.

Gale, William G. and Janet Holtzblatt. 1997. On the Possibility of a No-Return Tax System. *National Tax Journal* 50(3): 475–485.

Gale, William G., Scott Houser, and John Karl Scholz. 1996. Distributional Effects of Fundamental Tax Reform. In *Economic Effects of Fundamental Tax Reform,* edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 427–431.

General Accounting Office. 1996. *Tax Administration: Alternative Filing Systems.* GAO/GGD–97–6. October.

General Accounting Office. 1998. *Tax Administration: Potential Impact of Alternative Taxes on Taxpayers and Administrators.* GGD–98–37.

Gentry, William M., and R. Glenn Hubbard. 1997. Distributional Implications of Introducing a Broad-Based Consumption Tax. *Tax Policy and the Economy* 11: 1–48.

Gillis, Malcom, Peter Mieszkowski, and George R. Zodrow. 1996. Indirect Consumption Taxes: Common Issues and Differences Among the Alternative Approaches. *Tax Law Review* 51: 725–774.

Graetz, Michael J. 1997. *The Decline (and Fall?) of the Income Tax.* New York: W.W. Norton and Company.

Gruber, Jonathan, and James Poterba. 1996. Fundamental Tax Reform and Employer-Provided Health Insurance. In *Economic Effects of Fundamental Tax Reform,* edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 125–170.

H.R. 2001. "The National Retail Sales Tax Act of 1997."

H.R. 1040 and S. 1040. "Freedom and Fairness Restoration Act of 1997."

Hall, Arthur. 1996. Compliance Costs of Alternative Tax Systems II. Testimony before House Ways and Means Committee. March 20.

Hall, Robert, and Alvin Rabushka. 1983. *Low Tax, Simple Tax, Flat Tax.* New York: McGraw-Hill.

Hall, Robert, and Alvin Rabushka. 1995. *The Flat Tax,* Second Edition. Stanford, CA: Hoover Institution Press.

Hines, James R. Jr. 1996. Fundamental Tax Reform in an International Setting. In *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 465–502.

Joint Committee on Taxation. 2000. "Budget Netural Tax Rate for H.R. 2525." Memorandum. April 7.

Joint Economic Committee. 1998. The *Economics of the Estate Tax*. December.

McLure, Charles E. Jr., and George R. Zodrow. 1996. A Hybrid Approach to the Direct Taxation of Consumption. In *Frontiers of Tax Reform,* edited by Michael J. Boskin, Stanford, CA: Hoover Institution Press, 70–90.

Metcalf, Gilbert E. 1997. The National Sales Tax: Who Bears the Burden? Cato Policy Analysis No. 289.

Mieszkowski, Peter, and Michael Palumbo. 1998. Is a National Retail Sales Tax Administrable?: A Proposal for a Hybrid NRST. Working Paper.

Mieszkowski, Peter and Michael Palumbo. 2000. Distributive Analysis of Fundamental Tax Reform. Mimeo.

Munnell, Alicia H. 1988. Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes. *New England Economic Review* Nov./Dec.: 3–28.

Murray, Matthew N. 1997. Would Tax Evasion and Tax Avoidance Undermine a National Retail Sales Tax? *National Tax Journal* 50 (1): 167–82.

Payne, James L. 1993. *Costly Returns: The Burdens of the U.S. Income Tax System.* San Francisco, CA: ICS Press.

Pearlman, Ronald. 1996. Transition Issues in Moving to a Consumption Tax: A Tax Lawyer's Perspective. In *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 393–434.

Pechman, Joseph A. 1990. The Future of the Income Tax. *American Economic Review* 80(1): 1–20.

Repetti, James R. 2000. The Case for the Estate and Gift Tax. *Tax Notes* March 13: 1493–1510.

Ring, Raymond J., Jr. 1999. Consumers' Share and Producers' Share of the General Sales Tax. *National Tax Journal* 52(1): 81–90.

Seltzer, David R. 1997. Federal Income Tax Compliance Costs: A Case Study of Hewlett-Packard Company. *National Tax Journal* 50(3): 487–93.

Slemrod Joel. 1984. Optimal Tax Simplification: Toward a Framework for Analysis. In *Proceedings of the Seventy-Sixth Annual Conference on Taxation*. Columbus, Ohio: National Tax Association-Tax Institute of America.

Slemrod, Joel. 1989a. Complexity, Compliance Costs, and Tax Evasion. In *Taxpayer Compliance, Volume 2: Social Science Perspectives,* edited by Jeffrey A. Roth and John T. Scholz. Philadelphia: University of Pennsylvania Press.

Slemrod, Joel. 1989b. The Return to Tax Simplification: An Econometric Analysis. *Public Finance* Quarterly 17(1): 3–27.

Slemrod, Joel. 1996. Which is the Simplest Tax System of Them All? In *Economic Effects of Fundamental Tax Reform*, edited by Henry J. Aaron and William G. Gale. Washington, DC: Brookings Institution Press, 335–391.

Slemrod, Joel and Jon Bakija. 1996. Taxing Ourselves: A Citizens Guide to the Great Debate Over Tax Reform. Cambridge, MA: MIT Press.

Slemrod, Joel and Marsha Blumenthal. 1996. The Income Tax Compliance Cost of Big Business. Public Finance Quarterly 24(4): 411–438.

Slemrod, Joel and Nikki Sorum. 1984. The Compliance Cost of the U.S. Individual Income Tax System. National Tax Journal 37(4): 461–74.

Slemrod, Joel and Shlomo Yitzhaki. 2000. Tax Avoidance, Evasion, and Administration. NBER Working Paper No. 7473. Cambridge, MA: National Bureau of Economic Research.

Steuerle, C. Eugene. 1997. Paying Taxpayers to File Electronic Returns. Tax Notes October 27: 477–478.

Office of Management and Budget. 1998. Draft Report to Congress on the Costs and Benefits of Federal Regulations. Federal Register 63(158): 44034–44099.

Vaillancourt, Francois. 1986. The Administrative and Compliance Costs of the Personal Income Tax and Payroll Tax System in Canada. Toronto: Canadian Tax Foundation.

Weisbach, David A. 1999. Implementing the Flat Tax. Mimeo. University of Chicago Law School, July 20.

Zodrow, George R. 1999. The Sales Tax, the VAT, and Taxes in Between—Or, Is the Only Good NRST and 'VAT in Drag?'. National Tax Journal 52(3): 429–42.

Zodrow, George R. 2000. Transitional Issues in the Implementation of a Flat Tax or a National Retail Sales Tax. Mimeo.

Table 1

The Economic Growth and Tax Relief Reconciliation Act: Effective Dates and Revenue Costs of Selected Provisions

Provision	Highest Annual Tax Cut	2001–2011 Tax Cut	Phase-in Begins	Phase-in Complete	Phased Out By
Reduce marginal income tax rates	63.0	420.6	2001	2006	2011
Abolish estate tax	53.9	138.0	2002	2010	2011
Create 10 percent bracket	46.0	421.3	2001	2002	2011
Double child credit	26.2	171.8	2001	2010	2011
Marriage penalty	11.0	63.3	2005	−varies-	2011
Repeal restrictions on itemized deductions and personal exemptions	9.4	33.0	2006	2010	2011
Pension and IRA provisions	6.7	49.6		−varies-	
Nonrefundable credit	2.1	10.0	2002	2002	2007
Roth 401(k)s	0.4	−0.3	2006	2006	2011
AMT Relief	4.6	13.9	2001	2001	2005
Deduction for education expenses	2.9	9.9	2002	2004	2006
All provisions	187.0	1,348.6		−varies-	2011

Source: Joint Economic Committee on Taxation JCX–50–01. "Summary of Provisions Contained in the Conference Agreement for H.R. 1836, the Economic Growth and Tax Relief Reconciliation Act of 2001". May 26, 2001.

Table 2

Surveys of Individual Taxpayer Time

Survey	Arthur D. Little	Slemrod and Sorum	Blumenthal and Slemrod
Data Source	National random survey of 6,200 individuals [a]	Random survey of 2,000 Minnesota residents	Random survey of 2,000 Minnesota households
Response Rate	65.3%	32.7%	43.4%
Sample Size [b]	3,750	600	708
Types of Returns	1983 federal income	1982 federal and state income	1989 federal and state income
Hours Per Activity (in billions)			
Recordkeeping	0.7	1.3	1.7
Learning	0.3	0.2	0.4
Time with Preparer	—	0.4	0.2
Preparing Return	0.5	0.1	0.5
Sending	0.1	—	—
Rearranging Financial Affairs	—	—	0.3
Total Hours	1.6	2.1	3.0
Value of Time	—	$10.65/hour in 1982$ $13.69/hour in 1989$	$10.09 in 1989 $
Out-of-Pocket Costs	—	$44/return in 1982$ $57/return in 1989$ [c]	$66/return in 1989 $
Total Costs for Individuals	—	$26.7 billion in 1982$ $34.1 billion in 1989$	$37.6 billion in 1989$ $34.8 billion w/ same activities as 1982
Adjustments to Survey (if any)	Survey results were used to obtain models for estimating taxpayer burden. Estimates above from models.	Weighted nationally. Accounting for biases in estimates, authors suggest estimates could be as low as $17 billion.	Weighted nationally.

[a] Arthur D. Little also surveyed 4,000 corporations and partnerships, with a response rate of 36.8 percent. Businesses found to spend 1.6 billion hours on recordkeeping, 0.1 billion hours on learning, 0.1 billion hours on obtaining materials, 0.1 billion hours on finding and using a preparer, 0.7 billion hours on preparing the return, and 0.1 billion hours on sending. Total business time: 2.7 billion hours.

[b] The sample size was reduced by incomplete or inconsistent responses, as well as nonrespondents.

[c] Blumenthal and Slemrod report that the average out-of-pocket expenditure for 1982 taxpayers (in 1989 dollars) was $45. This appears inconsistent with the estimate shown in the Slemrod and Sorum study, which shows that the average out-of-pocket expenditure for 1982 taxpayers was $44 in 1982 dollars—which would be consistent with $56.5 in 1989 dollars.

Table 3

Estimates of Costs of Operating Income Tax System: 1995

Components	Slemrod 1995	Hall [a] 1995	Payne (1985 in 1995$)
Individuals			
Hours Data	Blumenthal and Slemrod	OMB estimates of average hours (ADL models for 1995)	ADL models for 1985
Total Hours	2.8 billion	1.2 billion	1.8 billion
Valuation	$15/hour (after-tax hourly wage)	$39.6/hour (average labor cost of IRS and Price-Waterhouse)	$40/hour (average labor cost of IRS and Arthur Andersen)
Value of Time	$42 billion	$46 billion	$73 billion
Out-of-Pocket	$8 billion	—	$8 billion
Total Costs	$50 billion	$46 billion	$81 billion

Estimates of Costs of Operating Income Tax System: 1995—Continued

Components	Slemrod 1995	Hall[a] 1995	Payne (1985 in 1995$)
Businesses			
Hours Data	ADL survey in 1983	OMB estimates of average hours (ADL models for 1995)	ADL models for 1985
Total Hours	800 million	2.4 billion	3.6 billion
Valuation	$25/hour	$39.6/hour (average labor cost of IRS and Price-Waterhouse)	$40/hour (average labor cost of IRS and Arthur Andersen)
Total Costs	$20 billion	$95 billion	$145 billion
Other Taxpayer Costs	N.A.	N.A.	$27 billion[b] (avoidance, evasion) $18 billion (enforcement burden)
Total Compliance Costs	$70 billion	$141 billion	$271 billion
Total Administrative Costs	$5 billion	—	$6 billion
Total Operating Costs	$75 billion	—	$277 billion

[a] Hall includes individual income tax returns with Schedules C and F in the business category. The other estimates include these returns in the individual category.
[b] Payne would include $236 billion that he estimates represents the distortionary effects of the income tax. Such costs are not typically included in the operating costs of the tax system and are not included in the table.

Chairman HOUGHTON. All right. Well, thanks very much, Mr. Gale. Let me start off though, if I could, a minute. And I don't know how the others in the panel feel about this, but you know I think when you get into form and structure and basic concepts, I think we are dealing with something which is very, very difficult. When we are even dealing with policy, that is difficult. What I am thinking about is just the mechanics, just some of the detailed mechanics of simplification and redundancy and things like that. And the reason I say that is that if you know, 1 to 10, if 10 is the overall tax structure and 1 is the individual return, if we can just do a few things, as I like to say, waiting for the bank heist, why can't we knock off a couple of gas stations. And if we can do something simple it would be far better because I have a feeling that if you look back in years past nothing has ever gotten done. There have been so many different tax proposals, so many different suggestions, and we never have gotten off the dime here.

It would seem to me if we could do two things, and I am just talking for myself, if we could look at those specific things which some of you have mentioned in your testimony, so we could do them tomorrow, I mean, I don't mean next week, I mean tomorrow, that are not subject to legislation but as sort of an administrative fix, then also we can begin to make Congress aware of the fact that they are really the culprit, because Congress does these things. And as a Member, I criticized President Clinton for this and it was unfair of me because we do the same thing. I can remember him giving one of his State of the Union speeches, saying we have got to get rid of tax credits, they are a curse on the tax system, and next thing that came up there were 28 different tax credits. We do the same thing ourselves. We never think of the cost-benefit. We never think of this.

So if there could be a beginning of the recognition of our part in this whole puzzle but also get together certain specifics so at the end of this year we can look back and say we did something, it wasn't very much but it was a start. That is what I am looking for. I don't know whether you gentlemen have any comment on that or not?

Mr. STEUERLE. I agree with you, Mr. Chairman. I think often the perfect is the enemy of the good. It seems to me, as you are arguing and as Mr. Gale emphasized this in his testimony, there are a lot of the tax laws that are inevitably going to be complex. It is not just policy, it is also that taxes are based on transactions, that people have to record transactions. When one promises the world simplicity and can't deliver it, then at least politically one is worse off almost than doing nothing; whereas if one promises a modest amount of improvement and delivers on it, I think that becomes quite believable.

I do think the types of simplifications that the Joint Committee put forward are exactly of that latter. I think they are quite doable. I do think also, however, as I emphasized, I think there are two processes that you have to think about. One is the process with respect to legislation that is already passed. Here I think one would emphasize things like the Joint Committee report. Mrs. Thurman emphasized this, I think, in her questions to Lindy Paull: you think about the processes that we undergo when we pass due legislation. Before we pass a bill can't we just put one person at the table whose only job is to report on simplification? It is not that simplification would always win out, but it would be given great weight in the process.

Have the IRS there, force them to produce any tax form they can in time before you pass the bill. I can tell you a lot of enactments would not be made if you actually just saw the tax form. I actually did this once as Deputy Assistant Secretary of the Treasury. It changed some legislation at the last minute. So first is process reform with respect to current legislation.

Second, past legislation is harder. If you act as in the last tax bill, and you can't create any losers, it is very hard to get simplicity because you are always patching on to an existing system. And patches usually add complexity. I give an example in my testimony of what happened with the child credit, the refundable child credit. If there was going to be refundability, everybody, left and right, conservative and liberal, agreed that the simpler way to do it would have been just to phase out the earned income credit more slowly. But for a variety of political reasons that wasn't on the table. So you got into this world of having to do it through the refundable child credit. And then there was a particular set of potential losers who were families with three or more children. We couldn't let them lose, so we had to keep their refundable credit, too. We ended up with this maze.

Chairman HOUGHTON. Well, listen, thank you very much. My time is really up. I would like to ask Mr. Coyne.

Mr. COYNE. Thank you, Mr. Chairman. Mr. Gale, are you familiar with the attempts that were made, in fact included in the recent tax bill, tax legislation, relative to simplifying the earned income tax credit provision?

Mr. GALE. Yes, in terms of simplifying the income definitions and the phase-outs, yes.

Mr. COYNE. What are your thoughts on that and I wonder if could you tell us what more you think needs to be done in the area of the earned income tax simplification?

Mr. GALE. I think that the two bright spots in the tax bill for simplification were first the earned income tax credit (EITC), simplifying and clarifying the income definition in terms of the various parts of the program and, second, the repeal of the personal exemption phase-outs and the limitations on itemized deductions. Those two bright spots of course are swamped by the sunset provisions and the phase-in and phase-out provisions which introduce an enormous amount of complexity or uncertainty in tax planning. I think the EITC itself is not tremendously complex right now. I think there is additional potential to simplify tax issues for low income households by combining the earned income credit, the child credit and the personal exemptions. Particularly if you have the same definition of a qualifying child for all three programs, there is no reason why when someone has stated their income and their number of kids that they shouldn't be able to kick right into all three of those programs at the same time without having to do separate worksheets. In the grand scheme of things that might not be the most important issue, but as the Chairman mentioned, we need to address these issues one at a time, and that is probably a very good place to start.

Mr. COYNE. Did you include that in your written testimony?

Mr. GALE. There is a reference to it, yes.

Mr. COYNE. We could get you to elaborate on that.

Mr. GALE. Certainly.

Mr. COYNE. Thank you.

Chairman HOUGHTON. Mr. McNulty.

Mr. MCNULTY. No questions.

Chairman HOUGHTON. Mr. Brady.

Mr. BRADY. Just briefly, Mr. Chairman. Like you, I have been excited and looking forward to this hearing. Simplification is such a key issue and of course like most things in life, as soon as you get excited about a hearing your schedule gobbles up all your time and you miss the testimony. I don't know if that ever happens to you, but I apologize for not being here.

I think one of the debates we have been having is whether we spend our time working to improve and simplify the Tax Code we have today, attacking the recommendations like our Chairman has spoken about or go after fundamental reform. I am convinced we have to do both, that we have to have two tracks, improve the product we have today in whatever area we can, as soon as possible, maybe using the criteria that the Joint Committee set out today or your own criteria. And I really am convinced that as long as we have an income-based and the income interpreted-based tax system we are going to have these problems. And at some point I think unless we have a sunset date for this Tax Code, that our grandchildren will be sitting here debating ways to simplify the current Tax Code. My experience is unless we set a date to sunset the Tax Code, whether it is 4 or 6 or even 10 years from now, my experience is if we set the deadline for midnight we will start working on it about 11:00. We will likely get done at 2:00, maybe later in the morning. But we do end up finishing that job. And I am convinced without some date certain that we have to really sit down, debate, work through this Tax Code in some time where we have a good thoughtful debate on it, perhaps removed from the immediacy of this election or this election cycle, that without both those tracks working that we will end up with very little in the end run.

Any comments from the panel?

Mr. GALE. Sure, just a couple. I think we would all like to see a simpler tax system. Personally I am concerned about proposals to sunset the Tax Code. I understand that saying we will make a decision by date X is a good model for a business with a hierarchal framework but I think a Congress is sort of 535 businesses all meeting at the same time, all with different objectives. And it is not obvious to me that if we sunset the Tax Code at a certain date that we would actually get a new Tax Code. There is no procedural guarantee that we could even come up with a new Tax Code. I think the risks inherent in that process are very large.

Mr. BRADY. Let me ask you this. Do you think we will get a Tax Code without a sense of urgency, a timetable in which to move? What would possibly motivate us to do that since there has not been an example of us doing that effectively to date?

Mr. GALE. Well, the best example I could put forward is the Tax Reform Act of 1986. It may be that we never do as much base broadening and rate reduction and simplifying again as we did then. But as Mr. Steuerle mentioned, I don't think we should let the perfect be the enemy of the good. I think that would be an excellent model to build on. And if sunsetting the Code would get us to a new Code and that new Code was guaranteed to be simpler, then sure, I would be in favor of it. But I think what sunsetting the Code does is put every single tax provision in the Code in play and essentially tells lobbyists now is the time to go out there and defend your tax provision. I think it would concentrate efforts to keep the Tax Code complicated rather than enhance efforts to simplify the system.

Mr. KEATING. Well, I think I would disagree here. I agree with you, Congressman. I think that it does make sense to take steps that have been identified now and move forward. The Joint Committee has suggested many useful proposals to simplify the tax laws, and I think more can be done as far as process. The fact that the Joint Committee had these recommendations even as late as April 27, I think was the exact date, a couple of very useful provisions made its way into the tax legislation. I think that is in part because they were already suggested and vetted by the Joint Committee on Taxation.

To the extent we have additional recommendations and we can induce competition between the various bureaucratic agencies, I think that might be useful.

One of the more revealing experiences that I had on the National Commission on Restructuring the Internal Revenue Service, with Mr. Coyne and Mr. Portman, was that whenever we had a hearing or an initiative come up before the Commission, wouldn't you know, the Treasury Department, that day or the day before, announced some new initiative to reform and restructure the IRS. I believe the mere existence of our Commission helped the Treasury and the IRS think harder about how they can do a better job.

The Joint Committee on Taxation for years has been tasked with the job of suggesting simplifications, but until this report came out, I don't remember anything quite so substantive from the Joint Committee.

A quadrennial commission, as I suggested in the testimony and as the National Commission on Restructuring the IRS has suggested, would bring private-sector input of people who would be appointed by the President or the Congress. Such a panel might help the Treasury Department and the Joint Committee stay on its toes and offer additional suggestions for simplification.

These are interim steps.

I do think that a sunseting of the Tax Code could work. I am not saying it would work. Of course, there are no guarantees, but the fact is that if Congress, on a bipartisan basis, approved legislation committing to fundamental overhaul of the Tax Code, that is a very important political statement. It sets into motion the machinery at the Treasury Department and the Joint Tax Committee and elsewhere to produce recommendations for simplification and fundamental overhaul.

It could prove useful, but I think what is most likely to happen if we are to see fundamental reform, it will be led from the White House, whoever is President. We saw that in the mid-eighties, and I think we may see it again sometime soon.

Mr. BRADY. Thank you. Thank you, Mr. Chairman.

Chairman HOUGHTON. Thanks very much. Mrs. Thurman.

Mrs. THURMAN. Thank you, Mr. Chairman.

Mr. Brady, I would tell you that I actually had an experience in the State of Florida where we actually sunsetted the codes, and I can tell you that by the time we came back, because we had about a year to look at it, we ended up with basically the same Tax Code we started with and nothing really took place.

Mr. BRADY. Shame on you.

Mrs. THURMAN. Well, no, it wasn't shame on me because, quite frankly, we tried to make some suggestions that were based on what we thought was sound policy. And in fact, it was all those other people coming back to the legislature saying, oh, no, don't touch us, we are not the culprit, go find somebody else to touch. So, you know, the politics do play in the policy.

Mr. Keating, let me ask you a question because it was alluded to in one of the answers here to one of the questions that I asked. Would you believe, then, that—and I think the Congress did try to do something correctly on simplification with the analysis. Other than the fact it is at the end instead of the beginning, would you believe that that would be a good place to start?

Mr. KEATING. You mean the analysis——

Mrs. THURMAN. I mean at the beginning, as we go through the changes, as versus at the end in the Committee report.

Mr. KEATING. Yes, I think so. If you look at the tax complexity analysis on this most recently passed tax legislation, I said it was a disappointment and an embarrassment. It was amazing to me that the analysis itself didn't even point out the positive things that were in the bill. There was no mention of the repeal of the phase-out of the personal exemption and itemized deductions. I don't think they talked much about the earned income tax credit simplification. So clearly it was the very last thing. It was put in there only because someone had to write something. I very much doubt it had any impact at all.

Mrs. THURMAN. The other thing——

Mr. KEATING. I think the numbers—perhaps there is something that could be done with the numbers. The joint tax is required to score——

Chairman HOUGHTON. Mrs. Thurman, did you want to say something?

Mr. KEATING. Year by year, but there is no requirement that they score; and I don't know how you would do it exactly, but we need something that would analyze how complexity would change with this legislation. So much of this is number driven to meet these targets, and if there are no targets for simplification, nothing to meet, it tends to take a back seat.

Mrs. THURMAN. And I would say to you, I think that while we talked about policy and the complexity over the last couple of years, or the last several years, has been driven from Congress—and I do believe that that is very true—my outcome is different, though. I think it has been a numbers game. I think when some group has wanted something to be done, we have gone into the Tax Code, we have taken something out of the Tax Code or added something into the Tax Code to meet a number, to pay for a program, to do something different as versus just, you know, changing policy up here, I think. And I think that has caused part of the complexity.

Which goes to the second part of this, then; and that is—and I think you said this, Mr. Keating, and I think that we got this report on April 27. My guess is that there could have been some conversations before we did the tax bill that was signed just before Memorial Day; that we in fact could have picked up some of those issues and used them in this recent tax bill signed into law that would have helped us with the complexity and, I think, would have straightened out many of the issues out there.

And if anybody would like to comment on that because, quite frankly, the second question to that is in reviewing this—and one of the questions I didn't get to ask Mrs. Paull was on the money. We are not talking about just walking in and changing some policy and walking away. You could be talking about some serious dollars that would have to be laid on the table to change the complexity of these Tax Codes.

Anybody want to give me an idea of what you think some of the costs would be? Have you done any of that or—you know, you don't have to answer. I mean, I kind of know the answer about the end of it; you know, that we should have looked at it in the tax bill in the beginning, but——

Mr. KEATING. Well, I think the fact that it came so late in the process limited the report's usefulness. And Gene talked earlier in his statement about the need to institutionalize these recommendations. When we had these huge budget deficits, each year the Congressional Budget Office was tasked with the job of coming up with examples of spending cuts and tax increases. I think if the Committee and the Finance Committee tasked the Joint Committee with coming up each year with ways to simplify the tax laws—and hopefully the report is done by December 31 so when the Congress starts its new session, it can use those ideas when the inevitable tax legislation comes up.

Mrs. THURMAN. But I need to say this, because I think some of those spending cuts you are talking about could have been done if we had used the surplus more wisely in paying down the debt. Because part of—it is not just spending on appropriations bills. It has been spending on the interest that we have had to pay on the deficit which has also caused us a huge problem that we can't cut.

Mr. STEUERLE. Mrs. Thurman, I totally agree with you on the importance of process reform, but I do think there is a certain extent to which Congress sets up rules. A lot of them are implicit; some of them are explicit. Sometimes the rule is "we have got 500 billion over 5 years." It is amazing how the entire process will revolve around that, and if $2 changes are made here then $2 has to come in over there.

Or they will set up a rule like the Senate did.

They had the Byrd rule which led to sunsetting the bill in the 11th year. It is amazing how rules do affect process. Suppose a rule—I am not saying this is the right rule—said after we pass legislation, we are going to take a day aside and only hear simplification testimony. I am not saying I would always want to do that, but if that was the rule and you knew you had to go through with it, then would you go through it? If you are not sure you have to go through it, you probably won't. The poor chairperson of the Subcommittee or Committee is trying to get all the votes together and is probably wracking his brain. The Joint Committee is working through the night. Nobody wants something added to their plate unless they know it has to be there.

So I think there are things that have to institutionalize a simplification process. As I mentioned, the Congressional Budget Office's (CBO) report on deficit reduction options, because it was constantly being there and hammered away at people, helped a lot. And I think raising the status of this Joint Committee report, putting a lot more in and getting outside help, would help a lot.

Finally, I think to do all this is going to require some level of additional resources. The Joint Committee and Treasury staffs are overworked, especially at tax bill-writing time; so there is a resource issue that has to be addressed at the same time.

Mrs. THURMAN. And I would say to you that this Chairman has actually met with some of the IRS people and the Commission in trying to figure out how we best can do that. So I give him a lot of credit for that, along with Mr. Coyne.

Chairman HOUGHTON. Thanks very much, Mrs. Thurman. Look, you know, big issue, big problem. And I just hope we don't stub our toe or look out the window on December 31 and think we have done a good job when we haven't.

I think we are really going to get into this, and I appreciate very much your testimony. We will continue it, and any other suggestions, please let us know. The hearing is complete.

[Whereupon, at 4:36 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of the American Bankers Association

The American Bankers Association (ABA) is pleased to have an opportunity to submit this statement for the record on "Tax Code Simplification."

The American Bankers Association brings together all categories of banking institutions to best represent the interests of the rapidly changing industry. Its membership—which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks—makes ABA the largest banking trade association in the country.

The federal tax system is greatly in need of simplification and reform. Many of the current rules have not kept pace with technological advances and changes in the global economy. Others have been in place for a number of years and do not adjust for inflation or no longer serve their original purpose. As a result, they have become increasingly restrictive on a broader base of taxpayers than originally intended when enacted by Congress or are so overly complex that they are rarely used.

Tax Code simplification is an extremely important goal, and we commend you for holding this hearing. We look forward to the upcoming simplification hearings and plan to provide more extensive comments in connection therewith. Our testimony covers a broad range of issues, some of which are included in the Joint Committee on Taxation's "Study of the Overall State of the Federal Tax System and Recommendations for Simplification."

SIMPLIFY THE INTERNATIONAL TAX REGIME

As technology and expanding trade opportunities change the global market place, financial institutions have had to make rapid adjustments in order to remain competitive with foreign financial entities. With respect to the international operations of U.S.-based financial institutions, the tax law has not kept pace with technological advances and changes in the global economy.

The ABA supports the enactment of legislation that would simplify the international tax law and that would assist, rather than hinder, U.S. financial institutions' global competitiveness. We agree with the observation that we cannot afford a tax system that fails to keep pace with fundamental changes in the global economy or that creates barriers that place U.S. financial services companies at a competitive disadvantage. In that regard, the ABA would like to commend Representatives Amo Houghton (R–NY) and Sander Levin (D–MI) for introducing the "International Tax Simplification for American Competitiveness Act" (H.R. 2018) in the 106th Congress. We understand that similar legislation is expected to be introduced in this Congress.

- **Permanent enactment of the Subpart F "active finance" provision**

ABA urges permanent enactment of the active finance exception to Subpart F. Under general income tax principles, the foreign income of a foreign corporation is generally not subject to tax even if it has been organized by a U.S. taxpayer. The U.S. taxpayer would not pay tax until the income is repatriated to the U.S. (e.g., as a dividend). We commend Representatives Jim McCrery (R–LA) and Richard Neal (D–MA), for introducing H.R. 1357 to permanently enact the subpart F active finance provision. We also commend Senate Finance Committee Chairman Max Baucus (D–MT) and Senator Orrin Hatch (R–UT) for introducing S. 676 in the Senate.

Subpart F was enacted to prevent passive foreign income (dividends, rents, interest, etc.) from escaping taxation through use of the deferral principle. As a result, it provides that passive income items are not eligible for deferral. However, Congress enacted an exception for such income if derived in the active conduct of a banking, financing or similar financial services business. This financial services exception was enacted in the Taxpayer Relief Act of 1997 as a temporary measure. It was later extended and modified by the Tax and Trade Relief Extension Act of 1998. The financial services exception reflects the belief of Congress that financial services businesses are "active" and should have appropriate deferral benefits. This temporary provision is scheduled to expire December 31, 2001.

Permanent enactment of the active financing provision is sorely needed to level the international business playing field, increase competitiveness and allow proper planning by U.S. financial services companies for the long term.

- **Simplify the foreign tax credit limitation for dividends from 10/50 companies**

The foreign tax credit rules impose a separate foreign tax credit limitation (separate baskets) for companies in which U.S. shareholders own at least 10 but no more than 50 percent of the foreign corporation. The old law 10/50 rule imposed an unreasonable level of complexity, which Congress sought to correct in the 1997 Tax Relief Act by eliminating the separate baskets for 10/50 companies using a "look through" rule. However, the 1997 Act change is not effective until after year 2002. We commend Representatives Sam Johnson (R–TX) and Robert Matsui (D–CA) for introducing H.R. 1357 to accelerate application of the look-through approach.

The ABA supports the Joint Committee's recommendation to immediately apply the look-through approach to all dividends paid by a 10/50 company irrespective of when the earnings constituting the makeup of the dividend were accumulated. Such change would dramatically reduce tax credit complexity and the administrative burdens on financial institutions doing business internationally. It would also help level the playing field with respect to global competitors.

SIMPLIFY ROUTINE CORPORATE REORGANIZATIONS UNDER SECTION 355

Internal Revenue Code Section 355 allows a corporation or an affiliated group of corporations to spinoff a business on a tax-free basis provided certain requirements are met. The rule requires that each of the divided corporate entities be engaged in the active conduct of a trade or business. For groups of corporations that operate active businesses under a holding company, the Code provides a "look-through" rule. However, the look-through rule requires that "substantially all" of the assets of the holding company consist of stock or active controlled subsidiaries, effectively preventing holding companies from engaging in spinoffs if they own almost any other assets. However, corporations that operate businesses directly can own substantial assets unrelated to the business and still engage in tax-free spinoff transactions. Holding companies that hold other assets must first undertake one or more costly and burdensome preliminary reorganizations solely to comply with this language of the Code. For many purposes, the Code treats affiliated groups as a single corporation. There is no tax policy reason in this instance to treat affiliated groups differently than single operating companies.

We commend Senator John Breaux (D–LA) for introducing S. 1158 in the Senate to modify the active business definition relating to distributions of stock and securities of controlled corporations. That bill would treat all corporations that are members of the same affiliated group as a single corporation and would do much to simplify routine corporate reorganizations.

ELIMINATE THE QUALIFIED SMALL–ISSUER EXCEPTION FOR CERTAIN BANK–QUALIFIED TAX EXEMPT BONDS

The Joint Committee report recommends that the small-issuer exception for bank-qualified bonds be eliminated and states that it is largely irrelevant given the availability of State bond pools. The ABA strongly disagrees with that recommendation.

Internal Revenue Code section 265(b) generally disallows the interest expense allocable to tax-exempt obligations acquired by a bank. However, the Code provides an exception for certain small issuers, allowing them to issue $10 million per year of "qualified tax-exempt obligations" (QTEOs), and allows banks to deduct the interest expense.

Elimination of the qualified small-issuer exception would greatly impede the quality of services small municipalities could provide to their citizens. Community banks rely upon QTEOs to provide finance services to small municipalities, many of which do not have access to State bond pools. The 1999 ABA Bank Portfolio Managers Survey Report results shows that tax-free municipal securities were ranked among the most common type of security in banks' investment portfolios, comprising an average of 16 percent of the total portfolio. (The most common security was callable agency securities, which comprised an average of 22 percent of a bank's portfolio.) Generally, smaller banks tend to hold larger investment portfolios than larger institutions, relative to their total assets. Accordingly, one might expect that the QTEO portfolio composition of smaller banks would be larger than the survey indicates.

Indeed, the ABA Community Bankers Council's Special Report of January, 2000, *Compliance, Competition and the Community Bank Tax Burden: Blueprint for Reform*, urges further expansion of QTEOs and points out that the 15 year old volume cap should be raised and indexed for inflation.

S CORPORATION SIMPLIFICATION

The ABA supports enactment of the Subchapter S Corporation Modernization Act of 2001 (H.R. 2576; S. 1201), a bill that would allow more community banks to convert to Subchapter S corporations. We commend Reps. Clay Shaw (R–FL.), Robert Portman (R–OH), and Robert Matsui (D–CA) for introducing a comprehensive subchapter S improvement bill (H.R. 2576) in the House of Representatives. Identical legislation (S. 1201) was introduced in the Senate by Senator Orrin Hatch (R–UT) along with Senators Wayne Allard (R–CO), John Breaux (D–LA), Phil Gramm (R–

TX), Blanche Lincoln (D–AR) and Fred Thompson (R–TN). S. 1201 incorporates many provisions from S. 936 that Sen. Allard introduced May 23. Both H.R. 2576 and S. 1201 contain numerous subchapter S simplification provisions, including the Joint Committee's recommendation that the special termination rule for certain S corporations with excess passive investment income should be eliminated.

SIMPLIFY TAX INFORMATION REPORTING

The financial services industry files the bulk of all information returns on behalf of the IRS. Modifications to the tax laws and regulations governing information reporting occur frequently, and most of these changes require significant and costly system upgrades along with additional administrative burdens. The ABA strongly believes that simplification in the area of tax information reporting is needed and could be accomplished with little or no revenue or administrative impact upon the IRS.

Some of the tax reporting simplification items recommended by ABA include eliminating changes to the backup withholding rate reductions as mandated by the Economic Growth and Tax Relief Act of 2001; raising the dollar threshold on form 1099–MISC; and making Form W–8BEN certifications permanent for businesses, foreign trusts and estates.

REPEAL THE ALTERNATIVE MINIMUM TAX

The ABA supports the Joint Committee's recommendation to repeal the Alternative Minimum Tax (AMT). We agree with the Joint Committee that the AMT no longer serves the original purposes for which it was intended and adds unnecessary complexity, time and expense to compliance with the federal tax laws. The problem is that the AMT is now reaching many more taxpayers than it was ever intended to reach.

SIMPLIFY ESTATE AND TRUST TAXATION

The ABA supports the Joint Committee's recommendation that the qualification and recapture rules contained in the special-use valuation and family-owned business deduction provisions should be conformed and believes it would improve these rules. However, without further simplification, the qualified family owned business provisions will continue to be overly complex and burdensome and will continue to be rarely used.

While the concepts behind these rules are certainly positive, in practice the family-owned business deduction provision has been too difficult to be used. In general, it is very burdensome and complex. The difficulty of fitting within the definition and maintaining that status, along with the paperwork required, has led to an unwillingness to utilize this provision. Certainly conforming the qualification and recapture rules would help move the process in the right direction. Hopefully in the future, further improvements can be made.

The Joint Committee recommended the elimination of the two-percent floor on miscellaneous itemized deductions. We agree that this provision has proven to be particularly troublesome to bank trust departments and is in need of immediate resolution.

Over the years, the two-percent floor has resulted in litigation and questions regarding what are appropriate miscellaneous itemized deductions. It would be a very beneficial move towards greater tax simplification to eliminate this floor. In one recent case before the U.S. Court of Appeals, the ABA prepared an amicus brief regarding whether certain costs were appropriate to not include within the two-percent floor. The briefs and discussion by the Court focused on the highly subjective test of determining whether and which costs would not have been incurred if the property were not held in a trust or estate. Subjective tests are very difficult to administer because of the many potential interpretations. Such provisions do not make good tax law, and should be removed from the books.

JOINT COMMITTEE ON TAXATION REFUND REVIEW THRESHOLD

No refund or credit in excess of a specified dollar threshold of any income tax, estate or gift tax, etc., may be made until 30 days after the date a written report on the refund is provided to the Joint Committee. The report contains a brief history of the tax situation of the taxpayer and an explanation of the causes of any refunds. Attached to the report are supporting documents prepared by the IRS. These documents discuss the amount of, and reason for, all the adjustments considered by the IRS for taxable years under review. The Community Renewal Relief Act of 2000 (Public Law 106–554; H.R. 5662) raised the threshold from $1,000,000 (where it had been set since 1990) to $2,000,000. While we welcome the increase in the threshold, the ABA believes the review threshold should be further increased to accelerate the issuance of refunds and to free up significant resources of the IRS, the staff of the

Joint Committee on Taxation and corporate taxpayers. We believe such increase would not materially impair the Joint Committee's ability to monitor problems in the administration of the tax laws.

OTHER SIMPLIFICATION RECOMMENDATIONS

We also believe the following simplification is sorely needed:

- Depreciation
  - Eliminate the mid-quarter convention
  - Establish minimum capitalization rules
  - Use the same methods of depreciation for all taxpayers
- Eliminate the communications excise tax
- Conform the prohibition on the use of private activity bond proceeds

CONCLUSION

The ABA appreciates having this opportunity to present our views on simplification of the federal tax system. We look forward to continuing to work with you on these most important matters.

Statement of the Association of Financial Guaranty Insurors, Albany, New York

Chairman Houghton and Chairman McCrery, the Association of Financial Guaranty Insurors (AFGI), a trade association of financial guaranty insurors,[1] appreciates the opportunity to submit testimony to your Subcommittees as you examine the complexity of the Internal Revenue Code of 1986, as amended, (the "Code"). In 1998 Congress amended the Code to add Section 8022(3)(b), to require the Joint Committee on Taxation (the "Joint Committee") to report at least once during each Congressional session on the overall state of the Federal tax system, including recommendations with respect to the possible simplification of the Code. In April of this year, the Joint Committee released its *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986.*[1] Volume II of the three-volume study, titled *Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System* (the "Joint Committee Recommendations") together with the rest of the study will be reviewed by the Subcommittees at your July 17th hearing.

The Joint Committee at Part VIII.E of its Recommendations (pages 377–78), proposes the elimination of Section 832(e) of the Code which it criticizes "as giving rise to complexity that achieves no Federal income tax goal, but rather, only a particular accounting result." The purpose of this testimony is to express AFGI's concern, for the reasons set out below, with Joint Committee's recommendation to eliminate Section 832(e) of the Code.

Background

Section 832(e) of the Code is a provision that addresses a serious financial problem faced by certain insurance companies in a manner that is revenue neutral to the United States Treasury. The financial problem was caused by material reserve requirements for losses not yet incurred (so-called "contingency reserves") established by state insurance regulators. These contingency reserve requirements had the unintended impact of diminishing the statutory capital of the subject insurance companies. It was not practicable to change the statutory accounting rules in various states in order to address this impairment of capital. Instead, Section 832(e) was crafted with the support of the state insurance regulators to create a statutory asset equal to the tax benefits that would be realized by insurance companies if and when actual losses occurred. More specifically, and as described in more detail below, Section 832(e) allowed the insurance company to deduct its contingency reserves for Federal income tax purposes, provided that the insurance company "invests" the tax savings from such deduction in non-interest bearing treasury notes called "tax and loss bonds" which, in turn, are treated as assets of the insurance company for statutory accounting purposes. Since the tax savings from the deduction are loaned to the Treasury on an interest-free basis, this arrangement is revenue-neutral to the Treasury. It remains impractical to change the statutory ac-

[1] The members of AFGI are ACA Financial Guaranty Corporation, Ace Guaranty Re. Inc., AMBAC Assurance Corporation, AXA Re Finance S.A., Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance, Inc., MBIA Insurance Corporation, RAM Reinsurance Company, and XL Capital Assurance, Inc.

counting rules in various states in order to address the concern currently addressed by Section 832(e). Section 832(e) of the Code remains the simplest answer to a complex problem, without cost to Treasury. Accordingly, AFGI respectfully submits that this provision remain in place.

Description of Section 832(e)

Pursuant to section 832(e) of the Code, insurance companies writing mortgage guaranty, lease guaranty, and tax-exempt bond guaranty insurance may, subject to certain conditions, take a deduction for federal income purposes for their contingency reserves representing amounts required by state law to be set aside in a reserve for losses resulting from adverse economic cycles. The deduction cannot exceed the lesser of (i) the insurance company's taxable income or (ii) 50 percent of the premiums earned on such guaranty contracts during the year. Such a deduction represents advantageous treatment for such companies because, under the general tax principles otherwise applicable, the companies would not be able to deduct such reserved amounts until the losses actually arose. The companies may take such a deduction, however, only to the extent that they purchase so-called "tax and loss bonds" in an amount equal to the income tax savings attributable to it.

The Internal Revenue Code does not specify the terms of the tax and loss bonds. Per the legislative history underlying section 832(e), they are non-interest bearing obligations issued by the U.S. Government. An insurance company may present the bonds for redemption only as and when it restores to income the associated deduction for contingency reserves. Reserves are restored to income as and when they are applied, per state regulations, to cover loss or to the extent the company has a net operating loss in a subsequent year. *See* Code sections 832(e)(5)(B) and 832(e)(5)(C). Further, the reserve deduction taken in any particular year with respect to mortgage and lease guaranty insurance must be fully restored to income in 10 years. The reserve deduction taken in a particular year with respect to tax-exempt bond insurance must be fully restored in 20 years. *See* Code sections 832(e)(5)(A) and 832(e)(6).

Legislative Origins of Section 832(e)

Section 832(e) of the Code was originally enacted in January 1968, effective January 1, 1967.[2] At that time it applied only to mortgage guaranty insurance. It was then amended in 1974 to include lease guaranty and tax-exempt bond insurance after state insurance regulators imposed contingency reserves on those lines of insurance. According to the legislative history, it was adopted in response to high contingency reserve requirements imposed by state regulatory authorities. These reserve requirements ranged up to as high as 50% of earned premiums and were often required to remain in reserve for as long as 15 years. According to the legislative history, imposition of a current federal income tax on the reserved amounts, when combined with the effect of operating expenses and a loss experience of approximately 30% of non-reserved premium, could impose a serious burden on the insurance company's working capital. In such circumstances, the company's federal income tax obligation could easily exceed the cash remaining from available—*i.e.*, unreserved—funds after payment of expenses and loss.

In response to this problem, Congress decided to allow such insurers to take a deduction for these contingency reserves. However, because the reserve requirements imposed by the state regulatory authorities were substantially in excess of that suggested by experience, deferral of tax on such reserves could result in an unwarranted windfall for the companies. As a result, Congress permitted the deduction only to the extent the insurance companies invested the tax benefit there from in non-interest bearing tax and loss bonds. Because the bonds were expected to qualify as assets for state financial regulatory purposes, this would relieve the cash flow problems the companies could experience. At the same time, because the bonds did not bear interest, it was believed that the U.S. Treasury would also be unaffected. Indeed, at the time of the 1974 amendment, the U.S. Department of the Treasury stated with respect to the legislation that:

> "[f]rom the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the non-interest-bearing obligations give the Treasury at all times the unrestricted use of the deferred tax dollars

[2] Before Section 832(e) was enacted in 1968, mortgage guaranty insurers relied upon a number of private letter rulings allowing them to deduct their contingency reserves as if they were unearned premium reserves (with respect to which a deduction was already allowed). Upon revocation of these rulings in 1967, Section 832(e) was enacted as a result of the express concern of Congress that the inability to deduct contingency reserves could impair an insurer's capital. *See* S. Rep. No 918, 90th Cong. 1st Sess. (1967), reprinted in 1967 U.S. Code Cong. & Admin. News, 2698–99. The provision was designed to "solve this unique problem created by unusual State requirements."

as if there were no deduction and as if taxes were in fact paid." (Emphasis added)

From an economic perspective with regard to the regular income tax, the U.S. Treasury remains in essentially the same position after the application of Section 832(e) as it would have been had that provision not been enacted. Although its nominal tax revenue is reduced at the time the deduction for reserves is claimed, it receives, on an interest-free basis, an amount equal to foregone taxes through the purchase of the tax and loss bonds. So, its economic position at the time the contingency reserve deduction is taken (and the bonds purchased) is no different from what would otherwise have been the case. Similarly, although it will have to redeem those bonds at some later time when the reserve is restored to income, that also will not adversely affect its economic position from what it otherwise would have been. If the reserve was restored because of a loss, the amount paid to redeem the bonds will exactly equal the amount by which its tax revenues would otherwise decline had a net deduction for that loss been permitted.[3] If, on the other hand, the reserves are restored to income at the end of the 10- or 20-year time limitation because they had not been fully absorbed by the losses experienced up until then, the amount paid to redeem the bonds will simply offset the increased taxes attributable to the restoration of the reserve to income.

Conclusion

The interaction between the Code and the state insurance regulators in the treatment of contingency reserves is a long and intricate one, beginning with the issuance of private letter rulings by the Internal Revenue Service when state insurance laws first imposed contingency reserves on mortgage guaranty insurance, and continuing with implementation of Section 832(e) in 1968 when those rulings were revoked and a revision to Section 832(e) in1974 when state insurance laws imposed contingency reserve requirements on lease guaranty insurance and tax-exempt bond insurance. In fact, the relationship has become so well established that the State of New York, when it enacted legislation in 1989 providing that financial guaranty insurance was subject to contingency reserves, specifically authorized the insurers to invest in "tax and loss bonds (or similar securities) purchased pursuant to Section 832(e) of the Internal Revenue Code (or any successor provisions)."

Even if one concedes that the Joint Committee's assertion that Section 832(e) of the Code and related use of tax and loss bonds does "give rise to complexity," it is a long-established complexity that permits financial guaranty insurers to comply with state-imposed contingency reserve requirements without impairing their capital—a result that benefits the insurance companies, the parties whose obligations are insured, and the investing public that owns those obligations.

Elimination of Section 832(e) will greatly increase the complexities faced by the insurers who would be forced to attempt to change the statutory accounting rules in various states and should they fail to do so, which is likely, would face the possibility of impairment of their capital, a detrimental result for the insurers, the insureds and the beneficiaries.

AFGI respectfully submits that Section 832(e) not be eliminated.

Statement of the Group Health Incorporated, New York, New York

Introduction

Group Health Incorporated ("GHI") is pleased to submit this written statement on tax simplification to the Subcommittees on Oversight and Select Revenue Measures of the Ways and Means Committee, for inclusion in the record of the joint hearing that was held on Tuesday, July 17, 2001.

GHI is a New York not-for-profit health service corporation. It provides insured health benefits coverage for about 2.2 million people. GHI supports the goals of tax

[3] Ordinarily, if a taxpayer has a loss, it will be able to claim a deduction and, as a result, will experience a reduction in what its income taxes otherwise would have been. Under section 832(e), however, a loss does not lead to such a decline in income tax revenue. Although the insurance company will claim a deduction for the amount of such loss, this deduction will be offset by the amount of the reserve restored to income. As a result, there will be no net change in taxable income, or tax revenue, at that time. Instead, the government will redeem an amount of tax and loss bonds equal to the tax savings the company experienced when it claimed the reserve deduction in an earlier year. Assuming tax rates have not changed in the interim, the amount paid to redeem the bonds will equal the amount by which taxes would (as a result of the loss) have declined had section 832(e) not been involved.

simplification which include reducing the complexity of the tax code, lessening taxpayer costs to comply with the code and, where appropriate, tax reductions achieved through simplification. Towards these objectives, GHI strongly supports the elimination of the Alternative Minimum Tax (AMT), in particular as it applies to not-for-profit health plans.

Background

Until 1986, not-for-profit health plans were not subject to federal income tax. This was based on the fact that that they were often locally based health insurers that were the insurers of last resort for low-income individuals and small groups. Frequently they had open enrollment periods where they accepted applications from people without regard to their insurability.

In 1986, the tax code was amended to provide that not-for-profit health plans like GHI and most of the nation's Blue Cross-Blue Shield plans were to be taxed on a basis similar to commercial insurers. However, recognizing their past, and continuing, community-based charitable missions, the formerly tax exempt not-for-profit health plans were also accorded special recognition in Section 833 of the Internal Revenue Code. This Section allowed these plans to take a special deduction from their income that was not available to commercial insurers. The special deduction is equal to 25% of claims and related expenses less the not-for-profit insurers adjusted surplus on January 1st of the tax year.

Not affected by the 1986 change in the tax code were certain not-for-profit HMOs. They continue to be exempt from federal income taxes.

Elimination of the AMT—Alternative Approaches

All businesses, including not-for-profit health plans, must calculate their federal income taxes in at least two different ways. The first is under the regular tax method. The second is under the alternative minimum tax method. As set forth by many other commentators, including the Joint Committee on Taxation (”JCT”), forcing taxpayers to calculate their taxes under the AMT creates unneeded complexity and is bad tax policy.

There are several ways the tax code could be changed to eliminate the AMT.

A. Complete Repeal of the AMT for All Businesses

The first way to reform and simplify the current tax system would be to completely repeal the corporate AMT as it applies to all businesses. This is an approach recommended by the Staff of the Joint Committee on Taxation in their recent study and strongly supported by GHI.

B. Repeal the AMT as it Applies to Not-For-Profit Health Plans

The second alternative would be to eliminate the AMT just for not-for-profit health plans as defined in Section 833 of the tax code. This approach would be more focused and aimed at providing much needed relief for those not-for-profit health plans that have chosen not to convert to for-profit status and have continued their evolving not-for-profit mission. Accordingly, this approach would be less costly to the U.S. Treasury and would result in targeted tax relief for a small segment of an industry; that segment that has chosen not to pursue conversion to for profit status.

Rationale for Eliminating the AMT for Not-for-Profit Health Plans

In addition to the JCT staff's arguments in favor of eliminating the AMT for all businesses, there are several unique arguments for eliminating the AMT for not-for-profit health plans. They include the following:

(1). No Economic Profit. The alternative minimum tax was enacted to address concerns that companies who earn an “economic profit” were avoiding Federal income tax. This reasoning does not apply to “not-for profit” organizations. Unlike a profitable “for-profit” corporation that derives economic income (income over expenses) that is then available for distributions to shareholders, a “not-for-profit” organization does not have economic income and has no shareholders. Under state law, most not-for-profit insurance organizations calculate a “surplus” which is generally required by law to either be set aside for reserve purposes or to be returned to policyholders generally in the form of reduced premiums or increased benefits. Moreover, there is no incentive for a not-for-profit to be profitable. Rather, the goal of a not-for-profit is to be viable, and to meet their not-for-profit mission.

(2). No State Income Tax or AMT Tax. Most not-for-profit health plan organizations are not taxed at the state level for income tax or AMT purposes, and should not be subject to the alternative minimum tax at the Federal level.

(3). Access to Capital. Unlike commercial insurers that have easy access to capital through the equity markets, not-for-profit health plans have limited access to the capital markets. Raising capital to invest in new products, computer systems and human capital has always been and remains a challenge for not-for-profit health plans especially as these plans must modify systems to address new legislative and regulatory incentives, such as HIPPA. This need to access capital issue has been one of the primary arguments made by health plans converting to for-profit status. Elimination of the AMT would allow not-for-profit health plans to use money that would otherwise be paid in taxes to reinvest in the operations of the plans and to compete more effectively in the marketplace.

(4). Level the Playing Field. Elimination of the AMT would help level the playing field between not-for-profit health plans and not-for-profit HMOs. The products of not-for-profit HMOs (as well as for-profit HMOs) and not-for-profit health plans have substantially converged over the years. In response to market conditions and customer demands, HMOs now offer many open and direct access products with limited, or non-existent, gatekeeper functions. Not-for-profit health plans, on the other hand, have added managed care features to their products in order to help control costs. In many markets it may now be nearly impossible to distinguish between an HMO, PPO or managed fee-for-service health plan without careful scrutiny of the plan documents. The current tax code, however, only grants full tax-exempt status to not-for-profit HMOs. Eliminating the AMT for not-for-profit health plans would have the practical effect of treating not-for-profit health plans and not-for-profit HMOs the same for Federal income tax purposes.

(5). Competitive Disadvantage. Retention of the AMT would leave not-for-profit health plans at a competitive disadvantage. Since such plans would not be able to benefit from a tax preference granted by Congress, while the current tax code still permits tax exempt status for similar plans (not-for-profit HMOs) in the same industry.

(6). Public Policy Need for Not-For-Profit Health Plans. The retention of not-for-profit health plans is an important public policy goals since such plans provide a competitive benchmark against which to measure for-profits in prices, coverage, competitive market innovations, efficiency and administrative costs. As a matter of public policy it should be desirable to maintain financially strong, competitive, not-for-profit health plans in the marketplace. Eliminating the AMT will help achieve this worthy public policy.

(7). Revenue Costs. The cost to the Treasury of eliminating the AMT for not-for-profit health plans would be relatively insignificant given the limited number of existing not-for-profit health plans. As a point of information, the number of not-for-profit health plans has been declining given the continuing conversion of not-for-profit Blue Cross-Blue Shield plans and other plans to for-profit status. The elimination of the AMT for not-for profit plans would serve as an incentive to encourage not-for-profit plans to maintain their mission.

For the reasons stated above, GHI strongly believes that Congress should eliminate the corporate AMT, or at the very least eliminate the AMT for not-for-profit health plans. GHI wishes to thank the Subcommittees for considering its recommendations to eliminate the Alternative Minimum Tax and would be happy to work with the Subcommittees further on this important issue.

Statement of the Investment Company Institute

The Investment Company Institute (the "Institute")[1] is pleased to submit this statement to the House Committee on Ways and Means Subcommittee on Oversight and Subcommittee on Select Revenue Measures for the first in the series of hearings on the need for simplification of the Internal Revenue Code and review of the Joint Committee on Taxation's study of the overall state of the Federal tax system. In its study, the Joint Committee recommended a number of simplifications that would affect retirement savings vehicles and other long-term savings vehicles, including education savings vehicles. The Institute strongly supports efforts by Congress to simplify the rules applicable to retirement and other long-term saving incentives, thereby increasing opportunities for Americans to save for their retirement and other long-term goals, including saving for their children's education.

Approximately 88 million Americans use mutual funds to save for retirement and other long-term financial needs. Two-thirds of all mutual fund owners have house-

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 8,444 open-end investment companies ("mutual funds"), 490 closed-end investment companies and 8 sponsors of unit investment trusts. Its mutual fund members have assets of about $6.868 trillion, accounting for approximately 95% of total industry assets, and over 83.5 million individual shareholders.

hold income under $75,000.[2] Mutual funds are a significant investment medium for employer-sponsored retirement programs, including section 401(k) plans, 403(b) arrangements and the Savings Incentive Match Plan for Employees ("SIMPLE") used by small employers, as well as for individual savings vehicles such as the traditional and Roth IRAs. As of December 31, 2000, mutual funds held about $2.4 trillion in retirement assets, including $1.2 trillion in Individual Retirement Accounts ("IRAs") and $766 billion in 401(k)s. We estimate that about 46% of all IRA assets and 45% of all 401(k) assets are invested in mutual funds.[3]

For savings incentives to work, the rules need to be simple. All too often, however, frequent legislative changes have led to complicated tax rules that are extremely difficult for taxpayers to understand. Frequent changes in law also create uncertainty. These considerations are important not only to taxpayers, but to financial institutions when they are considering whether to make long-term business commitments. Take, for example, changes to pension laws. Since the passage of the Employee Retirement Income Security Act in 1974, there have been over a dozen major amendments to pension laws and the related tax code sections. Since 1994 alone, Congress has passed five substantial pieces of pension-related tax legislation—the Uruguay Round Agreements Act of 1994, the Uniform Services Employment and Reemployment Rights Act of 1994, the Small Job Protection Act of 1996, the Taxpayer Relief Act of 1997 and the Economic Growth and Tax Relief Reconciliation Act of 2001. A number of these legislative changes, many supported by the Institute, have provided new opportunities for saving by increasing contribution limits to plans and IRAs and creating new savings vehicles, including Roth IRAs, SIMPLE plans and 529 plans. Many amendments to our pension laws, however, also have added unnecessary complexity and administrative burdens that serve as a disincentive to employers to sponsor retirement plans and to individuals to save for retirement. Easing these burdens will promote greater plan coverage and result in increased retirement savings.

The Institute has long supported efforts to enhance retirement savings and other long-term savings for Americans, including efforts that would simplify the rules applicable to IRAs and qualified plans, and enable individuals to better understand and manage their retirement assets. In general, we support the recommendations contained in the Joint Committee's report regarding simplification of various retirement and education savings vehicles. While the report made numerous recommendations worthy of support, we focus our testimony on three basic areas: (1) IRA eligibility rules; (2) individual account plan rules; and (3) education savings vehicles.

I. IRA Eligibility Rules

The Joint Committee's report recommends eliminating phase-outs relating to IRAs and eliminating the income limits on the eligibility to make deductible IRA contributions, Roth IRA contributions and conversions of traditional IRAs to Roth IRAs. The Joint Committee also recommends that the age restrictions on eligibility to make IRA contributions should be the same for all IRAs. Further, the Joint Committee recommends eliminating the nondeductible IRA. The Joint Committee's report states that the IRA recommendations would reduce the number of IRA options and conform the eligibility criteria for remaining IRAs, thus simplifying taxpayers' savings decisions. We strongly support these changes. We wish to emphasize, however, that the nondeductible IRA should be eliminated *only* if the other recommended changes are made.

Simplification of the IRA rules responds to an urgent need. Current IRA eligibility rules are so complicated that even individuals eligible to make a deductible IRA contribution are often deterred from doing so. When Congress imposed the current income-based eligibility criteria in 1986, IRA participation declined dramatically—even among those who remained eligible for the program. At the IRA's peak in 1986, contributions totaled approximately $38 billion and about 29% of all families with a household under age 65 had IRA accounts. Moreover, 75% of all IRA contributions were from families with annual incomes of less than $50,000.[4] However, when Congress restricted the deductibility of IRA contributions in the Tax Reform Act of 1986, the level of IRA contributions fell sharply and never recovered—to $15 billion

[2] *"U.S. Household Ownership of Mutual Funds in 2000," Fundamentals*, Vol. 9, No. 4 (Investment Company Institute, August 2000).

[3] *"Mutual Funds and the Retirement Market," Fundamentals*, Vol. 10, No. 2 (Investment Company Institute, June 2001).

[4] Venti, Stephen F. "Promoting Savings for Retirement Security," Testimony prepared for the Senate Finance Subcommittee on Deficits, Debt Management and Long-Term Growth (December 7, 1994).

in 1987 and $8.4 billion in 1995.[5] *Even among families retaining eligibility to fully deduct IRA contributions, IRA participation declined on average by 40% between 1986 and 1987, despite the fact that the change in law did not affect them.*[6] The number of IRA contributors with income of less than $25,000 dropped by 30% in that one year.[7]

Indeed, fund group surveys show that almost fifteen years later, many individuals continue to be confused by the IRA eligibility rules. For example, in 1999 American Century Investments surveyed 753 self-described retirement savers about the rules governing IRAs. The survey found that changes in eligibility, contribution levels and tax deductibility have left a majority of retirement investors confused.[8] This confusion is an important reason behind the decline in contributions to IRAs from its peak in 1986.

For these reasons, the Institute strongly supports a repeal of the IRA's complex eligibility rules, which serve to deter lower and moderate income individuals from participating in the program. A return to the "universal" IRA would result in increased savings by middle and lower-income Americans.

The return of the "universal IRA," together with the availability of the Roth IRA, would eliminate the need for the nondeductible IRA—thus, further simplifying the IRA program. However, it is important to note that, in the absence of the Joint Committee's other changes, the nondeductible IRA serves an important purpose—enabling those individuals not eligible for a deductible or Roth IRA to save for retirement. Consequently, the nondeductible IRA should be eliminated *only* if Congress repeals the income limits for traditional and Roth IRAs.

II. Individual Account Plan Rules

Employer-sponsored retirement plans are a key part of the system of incentives and opportunities we provide for American workers to save for their retirement. However, as is the case with IRAs discussed above, the complexity of the rules applied to employer-sponsored plans frequently deters employers from establishing plans and workers from using them. By simplifying the rules governing retirement plans, Congress would encourage retirement savings.

The Joint Committee's recommendations, in part, focus on the rules applicable to various individual account type programs. This is a good place to start, as many Americans are confused by the various plan types, each with its own set of rules. Specifically, the Joint Committee recommends conforming the contribution limits of tax-sheltered annuities to the contribution limits of comparable qualified retirement plans. The Joint Committee notes that conforming the limits would reduce the recordkeeping and computational burdens related to tax-sheltered annuities and eliminate confusing differences between tax-sheltered annuities and qualified retirement plans. The Joint Committee also recommends allowing all State and local governments to maintain 401(k) plans. This, according to the Joint Committee's report, would eliminate distinctions between the types of plans that may be offered by different types of employers and simplify planning decisions. Indeed, Congress recently acted on some of these recommendations in recently enacted tax legislation.[9] More, however, can be done to simplify these plans and their rules.

The Institute supports such efforts to reduce the complexity associated with retirement plans—especially for workers, who struggle to understand the differences between 401(k), 403(b) and 457 plans. The ability of workers to understand the differences among plan types has become even more important as a result of the enactment of the portability provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001.[10] These provisions enhance the ability of American workers to take their retirement plan assets to their new employer when they change jobs by facilitating the portability of benefits among 401(k) plans, 403(b) arrangements and 457 state and local government plans and IRAs. The Institute strongly supports efforts by Congress to simplify and conform rules that apply to different plan types in order to assist workers in understanding their retirement plans.

---

[5] Internal Revenue Service, Statistics of Income.

[6] Venti, supra at note 4.

[7] Internal Revenue Service, Statistics of Income.

[8] American Century Investments, as part of its "1999 IRA Test," asked 753 self-described retirement "savers" ten general questions regarding IRAs. Only 30% of the respondents correctly answered six or more of the test's ten questions. Not a single test participant was able to answer all ten questions correctly.

[9] See, for example, Sections 611 and 615 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

[10] See Sections 641–643 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

III. Education Savings Vehicles

The Joint Committee recommends several simplifications related to education savings vehicles. First, the Joint Committee recommends eliminating the income-based eligibility phase-out ranges for the HOPE and Lifetime Learning credits. As with IRAs, we believe the phase-outs unnecessarily complicate these programs and serve to deter participation among those eligible.

Second, the Joint Committee recommends that a uniform definition of qualifying higher education expenses should be adopted. A uniform definition would eliminate the need to taxpayers to understand multiple definitions if they use more than one education tax incentive and reduce inadvertent taxpayer errors resulting from confusion with respect to the different definitions.

Third, the Joint Committee also supports simplifying the HOPE and Lifetime Learning credit programs by combining them into a single credit. Combining the two credits would reduce complexity and confusion by eliminating the need to determine which credit provides the greatest benefit with respect to one individual and to determine if a taxpayer can qualify for both credits with respect to different individuals. If Congress considers implementing this recommendation, it should take care not to reduce the total benefits available to individual taxpayers under the programs.

Finally, the Joint Committee recommends eliminating the restrictions on the use of education tax incentives based on the use of other education tax incentives and replacing them with a limitation that the same expenses could not qualify under more than one provision. The Joint Committee states in its study that this recommendation would eliminate the complicated planning required in order to obtain full benefit of the education tax incentives and reduce "traps for the unwary." We note, however, that Congress has improved the coordination of the HOPE and Lifetime Learning credits as a result of the recently passed tax legislation.[11]

We support Congress's efforts to simplify the rules applicable to various education savings vehicles. Savings for their children's education is a top priority for many working Americans. We applaud efforts to streamline the rules relating to education tax incentives. By reducing the complexity surrounding these various tax incentives and education savings vehicles, Congress will enable more Americans to take advantage of opportunities to save for their children's education.

IV. Conclusion

Today's individual and employer-sponsored retirement system has evolved into a complex array of burdensome requirements and restrictive limitations that can serve as barriers to retirement savings. The same holds true for education savings programs. Simplifying the rules relating to retirement and education savings vehicles would encourage greater savings by American workers.

Massachusetts Software & Internet Council
Boston, Massachusetts 02116
July 19, 2001

Allison Giles, Chief of Staff
Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

RE: Alternative Minimum Tax on Incentive Stock Options

Dear Ms. Giles:

On behalf of the Massachusetts Software & Internet Council, I would like to submit this statement for inclusion in the printed record of the hearing held on July 17 on Tax Code Simplification.

Incentive stock options (ISOs) were originally intended to encourage employees to maintain a long-term stake in their companies. An added benefit to the employee is the fact that the exercise of an ISO generally does not result in a taxable event.

This benefit is in contrast to the exercise of a nonqualified stock option, which results in the immediate recognition of compensation income, even if the stock purchased by exercising the option is not sold.

[11] See Sections 401(g) and 402(b) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

The favorable regular tax treatment for ISOs, however, is undermined by unfavorable treatment of ISOs for alternative minimum tax (AMT) purposes. Under the AMT, the gain between the grant price and the exercise price is treated as a preference item to be included in AMT income.

The AMT causes an acceleration of the taxable event for an ISO. For regular tax purposes, there is no taxable event until the ISO shares are sold. But the AMT causes a portion of the total tax to be moved up to the year of exercise. This result discourages employees from holding their options as a stake in their companies.

Moreover, because AMT calculations are so complex, a growing number of employees who have exercised ISOs, but who have seen the market value of their options decline below the exercise price, are now faced with significant AMT tax liability without having the resources needed to meet this liability.

This harmful consequence of AMT complexity is not limited to the employees of large companies. Thirty-eight companies, whose names are listed below, have authorized the Council to record their opposition to the AMT being applied to ISOs. Only a few of these companies are publicly held; most are privately held startups. Of these thirty-eight companies, thirty-two grant ISOs to eighty percent or more of their employees.

Because employees should be encouraged to acquire and hold stock in their employers, the Council recommends that the Internal Revenue Code be simplified by repealing the application of the AMT to ISOs.

Sincerely,

Joyce L. Plotkin
President

About the Massachusetts Software & Internet Council

The Massachusetts Software & Internet Council was founded in 1985 to promote the Massachusetts software and Internet industry, to help executives start, grow, and manage companies, and to help companies compete successfully in global markets. Currently there are 775 member companies. The Council organizes more than 50 meetings a year on the business aspects of managing software and Internet companies; conducts research on the industry; represents the software and Internet industry on technology-related public policy issues; creates innovative programs to deal with the shortage of skilled workers; and promotes Massachusetts as a center of technology leadership and innovation. Additional information about the Council can be found at http://www.msicouncil.org

Council members supporting repeal of the AMT on ISOs:

Trellix, Concord
Chamelon Network, Waltham
Endeca, Cambridge
Bitpipe, Boston
Torrent Systems, Cambridge
Framework Technologies, Burlington
TimeTrade Systems, Waltham
Eprise, Framingham
Into Networks, Cambridge
Axiomatic Design Software, Inc., Boston
Nexus Energyguide, Wellesley
KeyCommerce, Inc., Nashua, NH
QuadrantSoftware, Mansfield
Media 100, Marlboro
Authoria, Waltham
Zoesis Studios, Newton
Passkey, Quincy
IConverse, Inc., Waltham
Predictive Networks, Cambridge
FabCentric, Inc., Newton
e-Dialog, Lexington
Windstar Technologies, Inc., Norwood
MOCA Systems, Inc., Newton
CommercialWare, Inc., Natick
Acorn Communications Corp., Boston
SensAble Technologies, Inc., Woburn
WorkplaceIQ Ltd., Waltham
INTEGRA Technology Consulting Corp., Waltham
Funk Software, Inc., Cambridge

Blue Fang Games, Lexington
Sitara Networks, Waltham
Molecular, Watertown
XYVision Enterprise Solutions, Inc., Reading
Verilytics, Waltham
Incentive Systems, Inc., Bedford
Cerida Corporation, Andover
Moldflow Corporation, Wayland
Delphi Technology, Inc., Cambridge

Statement of Mortgage Insurance Companies of America

Introduction and Overview

This testimony outlines the comments of the Mortgage Insurance Companies of America on the Joint Committee on Taxation's proposal to eliminate Internal Revenue Code (”IRC” or “Code”) section 832(e). Without impacting the Federal Treasury, IRC section 832(e) embodies a series of special deduction rules that apply specifically to mortgage and lease guaranty insurance and to insurance of state and local obligations.

The Mortgage Insurance Companies of America (MICA) is a national trade association of the private mortgage insurance industry. The organization's members help loan originators and investors make funds available to home buyers with as little as 3-to-5 percent down—and even less for qualified borrowers—by protecting these institutions from a major portion of the financial risk of default. The private mortgage insurance industry's mission is to help put as many people as possible into homes sooner for less money down, and to ensure that they stay in those homes. By insuring conventional low down payment mortgages, MICA members have made homeownership a reality for more than 20 million families.

MICA strongly urges Congress to reject the Joint Committee on Taxation's (”JCT” or “Committee”) suggestion that Congress eliminate IRC section 832(e). Further, MICA believes that several of the premises upon which JCT bases its suggestion are inaccurate or fail to adequately reflect the true value of IRC section 832(e) for the mortgage insurance industry and its customers.

Description of Current Law and Joint Committee on Taxation's Proposal

Current Law

Congress enacted IRC section 832(e) in 1967 to address financial pressures on the mortgage guaranty insurance industry and related insurers resulting from States mandating the creation of contingency reserves for extraordinary losses arising during adverse economic periods. In many States, up to 50 percent of premiums received in any one year have had to be set aside for these contingency reserves. The size of these reserves created a substantial drain on the working capital of these insurers. Prior to enactment of IRC section 832(e), it was unclear whether the Code permitted companies to take a tax deduction to offset the cost of additions to these reserves. Without a tax deduction for these reserves, the companies were required not only to set aside massive funds for the reserves, but also to pay taxes on such reserved funds. Accordingly, since the portion of annual earned premiums required to be set aside in the reserves could not be used to pay current losses and other expenses, a current tax on premiums thus set aside further depleted the companies' assets and created a drain on working capital. A drain on working capital means that a mortgage insurer's ability to continue to insure more loans and thus expand homeownership opportunities for lower income families would be limited.

The Code addresses the strain these State rules place on a mortgage guaranty insurer's working capital through a unique statutory provision that was carefully drafted to meet the concerns of both the federal government and the insurance industry. Specifically, IRC section 832(e) allows companies to deduct payments made to such reserves, subject to the following limitation: the deduction can be no greater than the lesser of (i) the company's taxable income or (ii) 50 percent of the premiums the company earned on guaranty contracts for the same taxable year. Deductible amounts added to the reserve must be restored to income no later than the close of 10 years, regardless of loss experience or a State's funding requirements.

Congress determined, however, that insurers should not realize an economic benefit from this deduction, in large part because the State reserve requirements were so substantial. Further, Congress wanted to accomplish this requirement in a way to minimize the financial hardship on insurers. Accordingly, IRC section 832(e) requires insurers who take the deduction to purchase non-interest-bearing tax and loss bonds equal to the amount of tax savings attributable to the related deductions. The bonds cannot be redeemed without the amounts in the reserve fund being restored to income (and therefore made subject to the federal income tax), either because of heavy, catastrophic losses or through operation of the 10-year rule mentioned above. Amounts received in redemption of the bonds are typically used to pay income taxes resulting from inclusion in income of the previously deducted amount Congress knew that the economic impact of purchasing the tax and loss bonds would be ameliorated since the bonds qualified as assets for State financial regulatory purposes. In summary, IRC section 832(e) denies mortgage guaranty insurance companies the benefit of tax deferral with respect to amounts deducted, but does not create a drain on the company's assets since the bonds are recognized as assets for relevant state regulatory and accounting purposes and, therefore, mortgage insurers can continue to expand homeownership opportunities for families who do not have sufficient resources to save for a large down payment.

Joint Committee on Taxation Proposal

Description of Proposal

The Joint Committee on Taxation has suggested that IRC section 832(e) be eliminated. The Committee believes the section provides "no Federal income tax goal, but rather, only a particular financial accounting result." Contrary to the Committee's belief, however, IRC section 832(e) does in fact address the primary policy goal recognized by Congress in 1967, by helping to alleviate the burdens placed on the mortgage guaranty insurance industry through compliance with State and local reserve requirements. This in turn promotes home ownership. Any reduction or elimination of this important section of the Code would significantly impair the industry's ability to provide mortgage guaranty insurance.

Reasons for Maintaining Current Law

Although IRC section 832(e) could be viewed as adding some complexity to the Code, the few companies that actually utilize and depend on the section believe it is a fair, workable and necessary provision. Unlike Code provisions for many other industries, the current tax system for the insurance industry takes into account how State-mandated statutory accounting principles impact the industry's ability to operate and compete effectively. In particular, IRC section 832(e) reflects Congress' full appreciation of the burdens such State requirements place on the mortgage guaranty insurance industry, while also recognizing the economic realities of this business. Congress' original rationale for enacting Code IRC section 832(e) remains valid, and the same conditions, *i.e.,* adverse economic cycles and the State regulatory system for the mortgage guaranty industry, continue to exist.

IRC section 832(e) also strikes a delicate balance between the business realities of the industry and the revenue needs of the Federal government. The deduction makes it easier for companies to fund their State-mandated reserves, thereby setting aside funds in good years that can be used to pay claims for losses that may arise many years later.

The balanced compromise in IRC section 832(e) should not be disturbed. The industries' need for funded loss reserves has been addressed under a compromise that requires companies to purchase non-interest-bearing tax and loss bonds in an amount equal to their tax savings attributable to the deduction. Purchase of the bonds provides the Federal government with an immediate receipt of funds, while companies are permitted to use the bonds to offset the high costs of funding the reserves required by their long-term economic risks. The tax and loss bonds qualify as assets for State financial regulatory purposes and offset working capital problems insurance companies would otherwise experience.

Importantly, the private mortgage guaranty insurance industry's main competitor is a tax-exempt agency of the federal government, the Federal Housing Administration ("FHA"). Any elimination of IRC section 832(e) would reduce the private mortgage guaranty insurance industry's ability to compete fairly with the FHA.

Conclusion

An elegant solution for a unique situation, IRC section 832(e) has worked well for more than 30 years. IRC section 832(e) continues to help stabilize the mortgage guaranty insurance industry through periods of economic instability. It recognizes the conservative capital requirements imposed on the industry through State-required contingency reserves. Its intent is to provide a methodology to ameliorate the effects of these reserves on the working capital of the insurers. It achieves this at no cost to the Federal Treasury. Thusly, mortgage insurance companies are able to continue to expand homeownership opportunities by helping millions of American families afford homeownership. For these reasons, MICA urges Congress to reject any proposal that would limit or eliminate IRC section 832(e).

Contact List

1. Suzanne C. Hutchinson, Executive Vice President, Mortgage Insurance Companies of America, 727 15th Street N.W., 12th Floor, Washington, D.C., 20005 (202) 393–5566, (202) 393–5557 (fax)
2. Joe Komanecki, Mortgage Guaranty Insurance Corporation, P.O. Box 488, 270 East Kilbourn Avenue, Milwaukee, WI 53201, (414) 347–6706, (414) 347–6832 (fax)
3. Don Alexander, Akin, Gump, Strauss, Hauer & Feld, LLP, 1333 New Hampshire Avenue N.W., Suite 1000, Washington, D.C. 20036, (202) 887–4064, (202) 887–4288 (fax)
4. Janet Boyd, Akin, Gump, Strauss, Hauer & Feld, LLP, 1333 New Hampshire Avenue N.W., Suite 1000, Washington, D.C. 20036, (202) 887–4068, (202) 887–4288

Statement of National Association of Professional Employer Organizations (NAPEO), Alexandria, Virginia

The National Association of Professional Employer Organizations (NAPEO) appreciates the opportunity to submit this statement for the record of the Subcommittees' July 17, 2001 hearing on the need for simplification of the Internal Revenue Code. We congratulate the Subcommittees for their interest in these important issues and their willingness to reexamine the complex tax law for ways to reduce unnecessary compliance burdens and traps for the unwary that face many taxpayers today.

We anticipate that most of the comments that the Subcommittees will receive will focus on the need for broad-brush simplification of the Internal Revenue Code, and we applaud efforts in that regard. We wish to focus, however, on a narrow issue peculiar to the professional employer organization or "PEO" industry. That issue is the need for answers on how to apply the tax law to the unique situation presented by our industry. Of course, simplification can take many forms. The simplification that our industry needs is that which comes from eliminating the uncertainty of current law and specifying precisely how to apply the tax law to our particular situation.

A PEO assists mainly small- and medium-size businesses in fulfilling their responsibilities as employers by assuming the human resource function of its customers. The PEO generally assumes responsibility for paying wages and employment taxes to all the workers of its client companies. It maintains employee records, handles employee complaints, and provides employment information to workers, such as an employee handbook. Most significantly, the PEO provides workers a variety of benefits, including retirement (usually a 401(k) plan), health, dental, life insurance, and dependent care. For many of these workers, the provision of such benefits by the PEO represents their first opportunity to obtain these benefits.

PEO clients tend to be smaller businesses; as recent statistics show, these are the businesses least able to offer retirement and health benefits. The average number of employees that a NAPEO member's customer has is 18; the average annual wage is less than $20,000. PEOs can provide benefits to these workers on a more affordable basis because they can aggregate the workers of all of their customers together into a larger group, thereby obtaining economies of scale that enable them to maintain qualified plans. Moreover, PEOs have the expertise to operate these plans in compliance with a rather complex set of requirements imposed by the tax code and ERISA. Significantly, PEOs also bring workers under the protection of federal laws applicable only to large employers, providing workers such benefits as COBRA health care continuation coverage and benefits under the Family and Medical Leave Act—protections that would not otherwise been available to those workers.

As small- and medium-sized businesses have increasingly sought out the services of PEOs over the past decade, the industry has expanded to meet this demand. At the state level, NAPEO has in many cases sought recognition for PEOs and supported regulation, such as licensing, to ensure that the industry could grow in a manner that ensured quality services. At the Federal level, however, PEOs have been confronted with a tax code that was written long before the development of our industry. Therefore, the current rules governing who can collect employment taxes and provide benefits do not neatly fit a PEO, its customer and workers. In fact, under some interpretations of the tax law, PEOs could not do the very things that small businesses want and need—namely, collecting employment taxes and providing retirement, health and other benefits.

What the PEO industry and the IRS need is a map leading us through the intricate web of rules that govern employee benefits and the payment of payroll taxes. We are very pleased that Representatives Portman and Cardin have continued their efforts to help craft that map.

As many of the members of these subcommittees will recall, those efforts began with H.R. 1891, sponsored by Representatives Rob Portman (R–OH) and Ben Cardin (D–MD) in the 105th Congress. That legislation, the Staffing Firm Worker Benefits Act of 1997, was a comprehensive bill introduced in June 1997 aimed at answering a broad array of questions related to the tax status of a wide range of staffing firms. Comparable provisions were included in S. 2339 (105th Congress), bipartisan comprehensive retirement savings legislation introduced by Senators Bob Graham (D–FL) and Chuck Grassley (R–IA) in July 1998. In early 1999, however, serious concerns surfaced with respect to certain changes proposed in H.R. 1891 and S. 2339, including especially the elements of the bill affecting certain staffing firms other than PEOs.

Since the PEO industry felt that the concerns raised did not appear to directly affect PEOs (or could be dealt with through more careful drafting), we went back to the drawing board to try and come up with a narrower approach to our problem. The goal of this effort was to address the concerns that had been raised with respect to the comprehensive legislation, while still allowing PEOs to do what we were already doing for small businesses—providing benefits and collecting taxes. The result was a narrowly crafted bill, which was introduced in the last Congress by Representatives Portman and Cardin as the Professional Employer Organization Workers Benefits Act (H.R. 3490). Companion legislation was introduced in the Senate by Senators Graham and Connie Mack (R–FL) as S. 2979.

Since then, we have continued our extensive discussions with all interested parties and further refinements to the legislation have been made. These changes have led IRS Commissioner Rossotti to state that the revised bill would greatly improve tax administration. We are pleased to present the fruits of those efforts—a revised proposal that we believe addresses the concerns raised with respect to the original proposal.

Let me emphasize that this revised legislation is a completely different approach from the bill that was considered in 1997. Most significantly, the revised bill applies only to PEOs, i.e., arrangements where the PEO accepts responsibility for all or almost all of the workers at a worksite. It does not have anything to do with temporary staffing agencies or similar arrangements. Further, this bill by its terms applies only to two areas of the tax law—employment taxes and employee benefit law. It does not affect any other law, nor does it affect the determination of who is the employer for tax law or any other purpose. The bill specifically provides that it creates no inferences with respect to those issues. We hope that with this narrow focus, this legislation can be considered quickly on its own merits and will not be caught up in other unrelated issues.

In brief, what the new proposal provides is a safe harbor for PEOs which elect to meet certain certification requirements designed to protect the government against financial loss. A PEO that meets those requirements would be permitted to assume liability for employment taxes with respect to worksite employees and to offer retirement and other benefits to such workers. Significantly, the legislation explicitly prevents a customer from obtaining any better treatment under the tax code's nondiscrimination or other qualification rules under this proposal—a PEO's plans would be tested under these rules on a customer-by-customer basis.

Earlier this year, the Ways and Means Committee, and Representatives Portman and Cardin in particular, took the lead in substantially improving and streamlining the rules governing retirement plans. We are very pleased that President Bush signed those changes into law in June. That pension reform effort involved a variety of changes in the law that appeared complex on their face only because the existing law was so complex. In reality, however, the pension reforms contained in the June tax bill will result in a substantial simplification of the law through a lifting of a variety of duplicative and unnecessary administrative burdens that had been placed on retirement plans and by providing clearer answers on a number of issues.

Just as with the pension bill that Representatives Portman and Cardin authored, the changes needed for PEOs appear complex because the underlying law is so complex. In reality, needed legislation will substantially simplify the law for PEOs and the IRS by clearing up uncertainty and ambiguity in the current law in a manner that ensures not only that PEOs can continue to provide important employee benefits, but also that other important public policies are protected.

We ask the members of these subcommittees to work with Representatives Portman and Cardin to ensure that this PEO legislation is enacted as quickly as possible. This clarification of PEOs' ability to offer retirement and health benefits will permit our industry to continue to provide the workers of small and medium sized businesses with the benefits they need and deserve. With this legislation, current PEO customers will breathe a sigh of relief that the PEO plans in which their workers are currently participating will not be disqualified. PEOs will be able to establish new employee benefit plans under clear tax code rules. The marketplace's creative response to the difficulties of affording and providing benefits in a small business context will be allowed to flourish without the uncertainty imposed by outdated tax rules. We believe this represents an ideal model of the public-private partnership that can help address the impending retirement savings crisis as well as the immediate health care problem presented by the number of uninsured Americans, and we urge your support of that effort.

Statement of the National Council of Farmer Cooperatives

The National Council of Farmer Cooperatives ("NCFC") is a nationwide association of cooperative businesses owned and controlled by farmers. Its members include nearly 70 major farmer marketing, supply and credit cooperatives.

In connection with the Subcommittees' hearings on the need for simplification of the Internal Revenue Code (the "Code"), NCFC would like to bring to the Subcommittees' attention a proposal that would significantly simplify the tax treatment of dividends paid by cooperatives to shareholders that furnish start-up and expansion capital to such cooperatives. The proposal is contained in H.R. 2280, introduced by Representative Wally Herger and co-sponsored by Representatives Phil English, John Lewis, Jim Ramstad, Karen Thurman, J.D. Hayworth, Earl Pomeroy, and Fortney Stark. H.R. 2280 would allow cooperatives to pay dividends on capital stock or other proprietary capital interests without those dividends reducing net earnings eligible for the patronage dividend deduction to the extent that the cooperative's articles of incorporation, bylaws, or other contracts with patrons provide that such dividends are in addition to amounts otherwise payable to patrons from patronage sourced earnings during the taxable year. This bill is identical to a provision that was originally introduced as H.R. 1914 by Congressman Bill Thomas and included in a vetoed tax bill (H.R. 2488) of the 106th Congress.

NCFC believes that modifying the dividend allocation rule in the manner proposed by H.R. 2280 will promote the overall goals of tax simplification. Accordingly, NCFC urges the Subcommittees to consider including this bill in any future tax simplification measures.

Modification of the Dividend Allocation Rule Promotes Tax Simplification

Both the Joint Committee on Taxation and the Ways and Means Committee have articulated criteria to be used to determine whether a proposal satisfies the goals of tax simplification. (See Exhibit B.) NCFC believes that a modification of the dividend allocation rule in the manner contained in H.R. 2280 would satisfy all of the criteria for tax simplification.

First and foremost, H.R. 2280 would further the underlying policy of Subchapter T of the Code by ensuring that patronage income is subject to one level of tax. (See Exhibit A.) Second, as the current rule is mechanically complex and costly to administer, H.R. 2280 would achieve simplification and improved efficiency, understandability, feasibility and enforceability of Subchapter T of the Code. This simplification would reduce the burdens imposed on taxpayers, tax practitioners, and tax administrators and would greatly outweigh the costs of making a statutory change. Third, the solution proposed by H.R. 2280 would not create opportunities for abusive tax planning by providing an opportunity for nonpatronage income to be converted to patronage income and would comport with generally accepted tax principles. Fourth, H.R. 2280 would avoid the dislocation of tax burdens that occurs when the distribution of nonpatronage income to shareholders results in a third level of tax that falls on the cooperative (and, derivatively, all the members) and not only on the shareholders that are receiving the dividend. Finally, the revenue effect of modifying the dividend allocation rule (approximately $16 million over ten years) would comport with current budgetary constraints. Based on these reasons, NCFC submits that H.R. 2280 meets all of the criteria set forth by the Ways and Means Committee and should be adopted as a tax simplification measure.

Conclusion

The dividend allocation rule is fundamentally inconsistent with the policy goals of Subchapter T of the Code and adds complexity to the Federal tax laws, which should be removed by modifying the rule in a manner consistent with H.R. 2280. Accordingly, NCFC urges this Subcommittee to consider including H.R. 2280 in any future tax simplification measures.

EXHIBIT A

POLICY GOALS OF SUBCHAPTER T AND DIVIDEND ALLOCATION RULE

One of the overall policy goals of Subchapter T of the Internal Revenue Code (the "Code") is to subject a cooperative's "patronage income" to one level of tax and "nonpatronage income" to regular corporate income taxation. Patronage income is income derived from the cooperatives' business done with or for its patrons, and "nonpatronage income" is all of the other income of the cooperative. The single level of tax on the cooperative's patronage income is achieved by allowing the cooperative to take a patronage dividend deduction for the distribution of its net patronage income annually to its patrons based on their patronage business with the cooperative during the year. No similar deduction exists for the distribution of nonpatronage income. Thus, nonpatronage income is subject to two levels of tax.

The Dividend Allocation Rule

Under current Treasury Department practice and a predominance of the case law, if a cooperative pays a dividend on its capital stock or its other proprietary capital interests, the dividend is subject to the "dividend allocation rule." The "dividend allocation rule" requires this dividend to be treated as if it came from both patronage and nonpatronage operations of the cooperative and the allocation is made by employing the following calculation.

First, the dividend is treated for tax purposes as coming from the patronage and nonpatronage operations of the cooperative in proportion to the amount of business the cooperative has done in each of these operations. (For most cooperatives, this will mean that it will be treated as predominantly patronage income.) Second, the amount allocated to the patronage operation is then used to artificially decrease the cooperative's net patronage income (for deduction purposes), thus reducing the amount of the patronage dividend deduction and leaving patronage-sourced net earnings subject to tax at the cooperative level. *See* Treas. Reg. § 1.1388–1(a)(1)(iii). This creates an additional tax at the cooperative level, in effect a triple tax, merely because the cooperative has distributed a dividend on its capital stock.

The effect of the dividend allocation rule on a cooperative's taxation is illustrated by the following example:

EXAMPLE

A cooperative has gross income from patronage business of $200 and from nonpatronage business of $22. It has patronage expenses of $65 and nonpatronage expenses of $7, so that its patronage net earnings are $135 and its nonpatronage earnings are $15. *It pays a tax of $5 on its nonpatronage earnings*, leaving $10 in retained earnings from its nonpatronage business. *This $5 is the first tax paid on the earnings*.

Patronage Sourced Income (90%)		Nonpatronage Business (10%)	
Income from patronage business:	$200	Income from nonpatronage business	$22
Patronage expenses	[65]	Nonpatronage expenses	[7]
Patronage earnings	$135	Nonpatronage earnings:	$15
		Corporate taxes on $15	(5)
		After tax earnings	$10

Due to the "dividend allocation rule," if the cooperative pays a Capital Stock Dividend of $10 (the after-tax profits from its non-patronage business, i.e., retained earnings), the $10 will be prorated between the patronage earnings and nonpatronage earnings (which are $135 to $15, a 9 to1 ratio). Thus, $9 of the $10 of retained earnings will be deemed to come from the patronage net earnings, reducing the available patronage dividend from $135 to $126, which reduces the amount of patronage dividend available to the farmer member, a decrease of approximately 7%. This reduction in the patronage dividend deduction means that an additional $9 will become subject to tax. The cooperative has a full $135 in patronage net earnings and it only gets a patronage dividend deduction for $126; the difference ($9) becomes subject to tax at the cooperative level. Therefore, the cooperative pays a second corporate tax of say, $3, due to the reduction of the allowable patronage dividend deduction.

Patronage Sourced Income (90%)			
Patronage earnings Dividend Allocation Rule Patronage deduction	$135 [9] ($3 tax) $126	After tax earnings	$10

When the $10 Capital Stock Dividend is received by the stockholders, they are subject to tax on the receipt of this income, say $3 in tax. This $3 is the third tax paid on the earning and distribution of this income.

After Tax Earnings	
Dividend to Stockholders $10 Tax to stockholder on distribution	$10 (3)

From the original $15 of nonpatronage earnings to be distributed by the cooperative, approximately $11 or 73 percent has been paid in tax. At the cooperative level, $8 of the $15 or 53 percent is paid in tax, rather than $5 or 33 percent that would have been paid, but for the dividend allocation rule. These high percentages arise only because the cooperative paid a dividend on its capital stock. The effect of this calculation is to create a triple tax for the cooperative and the recipients of the dividend on capital stock, rather than the usual corporate double tax. It is a penalty imposed on the cooperative for paying a dividend on capital stock.

We urge the Committee to simplify the Code by eliminating this mandatory calculation for cooperatives paying dividends on capital stock or other proprietary capital interest, and allowing cooperatives to pay dividends on capital stock from their nonpatronage earnings and have these earnings subject only to the double tax which should apply to such earnings.

EXHIBIT B

CRITERIA FOR TAX SIMPLIFICATION

In April 2001, the Joint Committee on Taxation released its Study of the Overall State of The Federal Tax System and Recommendations for Simplification Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (the "Study"). In Volume I of the Study, the Joint Committee set forth the following criteria that it used to analyze possible simplification recommendations:

- the extent to which simplification could be achieved by the recommendation;
- whether the recommendation improves the fairness or efficiency of the Federal tax system;
- whether the recommendation improves the understandability and predictability (i.e., transparency) of the Federal tax system;
- the complexity of the transactions that would be covered by the recommendation and the sophistication of affected taxpayers;
- administrative feasibility and enforceability of the recommendation;
- the burdens imposed on taxpayers, tax practitioners, and tax administrators by changes in the tax law; and
- whether a provision of present law could be eliminated because it is obsolete or duplicative.[1]

In addition, the Joint Committee applied the following overriding criterion to each simplification proposal: whether the recommendation would fundamentally alter the underlying policy articulated by Congress in enacting the provision.

The considerations of the Joint Committee on tax simplification generally follow the considerations enunciated by the Ways and Means Committee. In 1990, the Ways and Means Committee articulated the following criteria to be used to determine whether a proposal satisfies the goals of tax simplification:

- whether the proposal would significantly reduce mechanical complexity or recordkeeping requirements;

[1] The Study, Vol. I., at p.9.

• whether the proposal would significantly reduce compliance and administration costs;
• whether the proposal would preserve underlying policy objectives of current law and not create or reopen opportunities for abusive tax planning;
• whether the proposal comports with generally accepted tax principles;
• whether the proposal would avoid significant dislocations of tax burdens among taxpayers;
• whether the simplification that the proposal would achieve outweighs the instability resulting from making any statutory change, as opposed to statutory repose; and
• whether revenue effects of the proposal would comport with current revenue and budget constraints.[2]

[An Additional attachment is being retained in the Committee files.]

Statement of the Hon. Charles B. Rangel, a Representative in Congress from the State of New York

The tax laws have become more and more complex. Something needs to be done. Tax simplification is at the top of everyone's "agenda" but not on the Republicans' real "action plan."

IRS data show that, in 1998, it took the average taxpayer nearly 8 2 hours to complete a simple Form 1040A (includes recordkeeping, learning about the law, preparing the form, and copying, assembling and sending the form to the IRS.) In comparison, this process took about 6 2 hours in the 1990s. (Similarly, the average low-income taxpayer filling out a Form 1040A and Schedule EIC (earned income tax credit) took about 8 hours and 48 minutes to complete the process.) This is just too long.

Some hoped that 1998 IRS reform requirement—that the Joint Committee on Taxation provide a "tax complexity analysis" on all tax legislation reported to the House—would encourage tax simplification at least for new tax proposals. But, I guess it has not had the desired result.

The President's recently-enacted tax cut bill, the Taxpayer Relief Act of 2001 creates significant additional complexity for taxpayers. The bill creates complexity in many areas, for example: uncertainty with sunsets of numerous provisions during the next nine years, and of the entire package of tax cuts at the end of 2011; growth in the number of taxpayers subject to the alternative minimum tax in comparison to prior law; confusing education tax provisions that apply to few taxpayers but require comparative review with previously-enacted provisions to determine the most beneficial option; and estate tax phase-out and reinstatement which may require annual review of estate plans.

The entire tax cut bill is sunset at the end of nine years.

Other provisions start late, end even earlier, or both. Not only is this budget gimmickry, it imposes complexity on taxpayers and the IRS.

The bill does nothing to protect millions of taxpayers from having to calculate tax twice—once for regular tax purposes and once for the alternative minimum tax. A recent Business Week article states: "Nothing better illustrates this tax bill's wallet-on-a string tricks than the alternative minimum tax provision. . . . The relief only lasts through 2004; by 2010, the new law will double the number of taxpayers subject to the AMT to 35.5 million. Clearly, today's lawmakers are punting this problem for future Congresses."

The bill does nothing to simplify, but rather makes more complex, the myriad of education tax benefits. These provisions actually have become a "trap for the unwary." It is almost impossible to figure out whether one should use the Education IRAs, HOPE or Lifetime Learning Credits, or Qualified Tuition Plans. The wrong decision could result in a family paying more tax. The bill contains a confusing and complex array of tax changes designed to benefit parents with children in college or who are saving for college. Since a number of the new benefits require taxpayers to choose among old or new incentives, families that rush out to use the new provisions may find that they would have been better off had they simply used the tax benefits available under prior law.

The bill's "estate tax repeal" provisions are incredibly complex. The bill creates an extremely complicated estate tax planning system, given the slow phased-in re-

[2] Committee on Ways and Means, U.S. House of Representatives, Written Proposals on Tax Simplification, 101st Cong., 2nd Sess., WMCP: 101–27, p. III–IV (May 25, 1990).

peal of the tax (with full repeal effective in 2010), retention of the gift tax, partial carry-over basis, and sunset after full phase-in (in 2011). The provisions have been called "estate tax planners' full employment act of 2001." The Democrats suggested a simple approach to reducing the tax B increasing the exemption amount B but the Republicans rejected this approach.

The tax cut bill attempted to provide some simplification relief relating to the earned income tax credit, phased-in repeal of the current law phase-out of personal exemptions (called "PEP"), and phased-in repeal of the current limit on itemized deductions (called "Pease").

The bill simplified, to some degree, the rules for the earned income tax credit. More needs to be done and we need to complete the task. The IRS Taxpayer Advocate, the Joint Committee on Taxation, the American Bar Association, accounting groups and many others have recommended simplification of the EITC. In fact, the Democrats have proposed simplification measures that the Republicans have rejected. There is no reason for further delays. Most EITC filers have their returns prepared by professionals in order to deal with this complicated area. The EITC laws are so complex that even tax professionals can't get it right. The "most common error" on paid-preparer returns relates to the EITC.

Two other problem areas that have been identified for many years relate to the personal exemption phase-out and limit on itemized deductions. The tax cut bill fails to resolve this problem immediately. Instead, taxpayers face a phased-in repeal over several years and benefit from full repeal for only one year (2010). They face sunset of the repeal for years 2011 and later.

Tax law complexity is not something that simply was created a decade ago and remains unresolved. Rather, the complexity of our tax laws is a continuing problem and process. The Congress tried to stop the piling-on of more and more complex tax provisions through a provision included in taxpayer rights legislation enacted in 1998.

Beginning with the 105th Congress, the Joint Committee on Taxation has been required to provide a "tax complexity analysis" of tax legislation approved by the Committee on Ways and Means. (At the end of each Committee report, one can see the JCT's analysis.) The JCT's tax complexity analysis reports, for tax legislation approved by the Committee over the past several years, do not show a commitment to tax simplification. Instead, the tax laws are becoming more difficult, burdensome and complex.

The most recent example of new tax code complexity was approved just last week B the Republican-designed non-itemizer tax deduction for charitable donations. For the first two years, the deduction for more than three quarters of taxpayers is worth $3.75 per person or less. In order to qualify for this tax benefit, according to the Joint Committee, taxpayers will need to read additional information on how to claim the deduction, fill out an additional line on the tax return, and keep records justifying their $25–$50 charitable contributions. Every year or so, the amount of eligible contribution changes, so taxpayers need to be careful to avoid mistakes and IRS audits. An obvious, more simple way to provide this tax benefit would have been to increase the standard deduction (e.g., by $20 to $25 for singles and $35 to $50 for couples in the first years).

In conclusion, it is one thing to talk about tax simplification. It is another to act. The time to simplify the tax law was yesterday. We need to develop a package of individual tax simplification measures and enact them on a bipartisan basis. Also, because the recent tax cut legislation utilized most of the available surplus, we will need to develop revenue offsets to the extent simplification measures have a cost associated with them.

Simplification does not come for free. There has to be a commitment to pay for the resulting reforms. You can count on me to support such an effort, if it is real. Hearings are nice and make everyone feel good. However, the public knows when simplification is "all talk and no action." They know on April 15th when they fill out their tax returns (or more likely when they have a preparer do it for them) whether the tax laws are more complex.

I encourage all Members of the Committee to work together and develop a tax simplification package for enactment this year. The public expects and deserves no less.

○