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TAX COMPLEXITY, COMPLIANCE, AND ADMINISTRATION: THE MERITS OF SIMPLIFICATION IN TAX REFORM

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

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TAX COMPLEXITY, COMPLIANCE, AND ADMINISTRATION: THE MERITS OF SIMPLIFICATION IN TAX REFORM

TUESDAY, MARCH 10, 2015

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

The hearing was convened, pursuant to notice, at 10:09 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Cornyn, Thune, Heller, Wyden, Stabenow, Cantwell, Nelson, Carper, Cardin, Brown, Bennet, and Casey.

Also present: Republican Staff: Chris Campbell, Staff Director; Mark Prater, Deputy Staff Director and Chief Tax Counsel; Eric Oman, Senior Policy Advisor for Tax and Accounting; and Preston Rutledge, Tax Counsel. Democratic Staff: Joshua Sheinkman, Staff Director; Ryan Abraham, Senior Tax and Energy Counsel; Adam Carasso, Senior Tax and Economic Advisor; and Michael Evans, Chief Counsel.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

I want to welcome everyone to today's hearing to discuss simplification of the tax code. I also want to thank our witnesses for appearing before the committee today and for the written testimony that they have submitted.

This is the third hearing that the committee has held to explore the principles of tax reform embraced by President Reagan nearly 3 decades ago. Those principles were: efficiency, fairness, and simplicity. We have held hearings on the importance of growth and efficiency and of fairness in tax reform. Today we will discuss the problem of complexity in the tax code and the merits of simplification.

There are many sources of complexity in our tax system, including a lack of clarity and readability; the use of the Federal tax system to advance social and economic policies; increased complexity in the economy; and the interaction of Federal tax laws with State laws, other Federal laws and standards, the laws of foreign countries, and tax treaties. The proliferation of credits, deductions, exclusions, exemptions, fees, and excise taxes, all of which were pre-

sumably intended by their proponents for good, also add to the overall complexity of our tax system.

Over the years, our tax code has grown to almost 4 million words. Today, approximately 59 percent of American households use paid preparers to do their individual income taxes, and another 30 percent use tax software to assist them. Taxpayers and businesses spend over 6 billion hours a year complying with tax filing requirements, with compliance costs totaling over $168 billion annually. That is larger than the entire economy of New Zealand. That amount would employ more than 3 million workers full-time at a wage of $25 an hour.

Wouldn't that money be better off in the hands of hardworking taxpayers instead of devoted to complying with our overly complicated tax code? Imagine a simpler tax code that greatly reduces compliance costs, resulting in a tax code that is efficient, effective, and accountable to taxpayers—in other words, a tax code that Americans can actually understand.

As was noted in the comprehensive report on tax reform by the Republican staff of the Finance Committee released in December, simplification often gets overlooked or relegated to secondary status in the tax reform discussion. That should not happen. Complex tax provisions—such as the personal exemption phase-out, or PEP, the overall limitation on itemized deduction, or Pease, or the AMT—effectively force taxpayers to seek constant help from professional preparers. Complexity should be a matter of concern for tax policymakers because it makes it more difficult, time-consuming, and expensive for tax payers to comply with the law and for the IRS to enforce it.

Complexity also reduces perceptions of fairness in the tax system and can decrease voluntary compliance with the tax laws. But of course, simplification is not without its trade-offs. For example, there is often a tension between fairness and simplicity. Simple statutes may not be fair because they lump together taxpayers who, in fairness, should be treated differently.

Statutes that comprehensively address relevant distinctions between taxpayers leading to fairness tend to be more complex. But no one said tax reform would be easy. These tensions and trade-offs come with the territory, but should not deter our efforts.*

Today we will hear from four witnesses on the front lines of the tax reform debate, and we look forward to discussing with them the pros and cons of simplification of the tax code.

I am happy to turn now to the ranking member, Senator Wyden, for his opening remarks.

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

OPENING STATEMENT OF HON. RON WYDEN, A U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you very much, Mr. Chairman. Mr. Chairman, thank you for scheduling this hearing. I think this is

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*For more information, *see also,* "Complexity in the Federal Tax System," Joint Committee on Taxation staff report, March 6, 2015 (JCX–49–15),
https://www.jct.gov/publications.html?func=startdown&id=4738.

another important step in our effort to build a bipartisan coalition for tax reform.

Mr. Chairman and colleagues, if you opened the hearing room curtains and looked outside, you would see that the gloom of winter is finally starting to lift. But instead of enjoying the beginning of spring, millions of Americans are stuck, buried under mountains of tax forms, documents, and receipts.

Around this time of year I start to hear from Oregonians that they are sick and tired of this painful process of filing taxes, and I am right there with them. Our tax system has become so incredibly complicated, so byzantine, that even someone who really knows their way around an accounting textbook has a hard time getting everything right.

The fact is, our overly complicated tax code divides taxpayers into very different worlds. There are the lucky few who can afford to hire tax pros who can game the system—game the system—with wash sales, option collars, and swap contracts, activities detailed in a report that I released last week. Then there is everybody else just trying to put their tax return in the rear-view mirror. It is a whole lot harder to use the code to your advantage if you are a middle-class person, a small business owner, or a family just getting by.

For example, when a family needs help paying for higher education, there are more than a dozen separate tax incentives to wade through. As if that was not complicated enough, each provision has its own set of rules and definitions.

The term "small business" is defined more than 40 different ways in the tax code. There are at least four definitions of a dependent, which is what most of us know as a child. Too often, simple errors on these and other tax breaks aimed at the middle-class or low-income families are labeled as fraud.

So, to avoid the hours and hours of paperwork, a lot of taxpayers look elsewhere for help. Many turn to software online, but they are often ending up spending a big chunk of their refund just to file. As we learned this year, there is often a security risk filing with software, so a lot of other taxpayers look to return preparers. But that can also be a big financial hit. Even worse, it exposes Americans to incompetence and abuse by unscrupulous return preparers who do not have the customers' best interest at heart. That is why Senator Cardin and I introduced the Taxpayer Protection and Preparer Proficiency Act to protect taxpayers by setting minimum requirements of competence for preparers.

In the end, comprehensive tax reform provides an opportunity to simplify America's tax system across the board. Some say it is impossible for tax reform to make the tax code simpler and fairer to all at the same time.

Colleagues, I just do not buy that. Simplification and fairness are cornerstones of any serious tax reform plan. They have been at the heart of the plans I developed with Senators Gregg and Coats, Senator Coats now being a member of our committee. Under those plans, which protected low-income and middle-class families, most Americans would file their taxes on a single 1-page form.

When the people up at *Money* magazine—and they know something about taxes—tried it out, it took a matter of minutes to com-

plete a typical return, not hours. Now, comprehensive reform is not going to iron out every wrinkle of the tax code, nor should it.

But the experience taxpayers go through every spring does not need to be such a horrendous nightmare. So let us look at the effort that is under way, the bipartisan effort in this committee, on tax reform. It is an opportunity to get people out from under all this paperwork, and let us give springtime back to the American taxpayer.

I look forward to discussing that with our witnesses today. Thank you again, Chairman Hatch, for scheduling this hearing.

The CHAIRMAN. Well, thank you, Senator.

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

The CHAIRMAN. Our first witness today is Carol Markman. Ms. Markman is the director of EP Caine and Associates CPA, LLC. She began her own CPA practice in 1980, representing clients before Federal and State taxing authorities for audits, and she has served as a tax consultant and a partner in various practices since.

Ms. Markman received her bachelor's degree in mathematics from City College of New York and her master's degree in accounting from LIU Post College of Management. Ms. Markman served as a member of the Internal Revenue Service Advisory Council from 2007 to 2010. She currently serves as a member of the AICPA Tax Executive Committee and has served as the president of the National Conference of CPA Practitioners. We are very pleased to have you here today.

The next witness is Dr. Mihir Desai. Dr. Desai is the Mizuho Financial Group professor of finance at Harvard Business School and a professor of law at Harvard Law School. His areas of expertise include tax policy, international finance, and corporate finance. Dr. Desai received his bachelor's degree in history and economics from Brown University, his MBA from Harvard Business School, and his Ph.D. in political economy from Harvard University.

Dr. Desai's professional experience includes working at CS First Boston and McKinsey and Company. He is an award-winning teacher at Harvard University, where he has built a second-year elective on international finance management.

Our next witness is Bruce Bartlett. Bruce, we are happy to welcome you back. He is a columnist and blogger for *The Fiscal Times* and was previously a columnist for *Forbes* magazine and *Creator's Syndicate*. His writing often focuses on the intersection between business and politics.

Mr. Bartlett received his bachelor's degree from Rutgers University and his master's from Georgetown. Mr. Bartlett has served as a staff member for Congressman Ron Paul, Congressman Jack Kemp, Senator Roger Jepsen, and the staff director of the Joint Economic Committee.

Aside from his congressional experience, he was a Senior Policy Analyst in the Reagan White House and Deputy Assistant Secretary for Economic Policy at the Treasury Department during the George H.W. Bush administration.

Our final witness is Mr. Keith Fogg. I am going to turn that over to Senator Casey, who will make the introduction of his fellow Pennsylvanian.

Senator CASEY. Mr. Chairman, thank you very much. I am honored to have the chance to introduce Keith Fogg. We are grateful you are here with us today.

Professor Fogg is a professor of law at Villanova University, one of the great law schools in the country. My brother is a graduate, so I wanted to make sure my brother Patrick Casey is on the record in that introduction.

Professor Fogg directs Villanova's Federal Tax Clinic, and of course has great expertise in the area and the subject matter of this hearing. He got his BA from the College of William and Mary, his law degree from the University of Richmond's T.C. Williams School of Law, and his LLM in tax also from the College of William and Mary, in this case from the law school, the Marshall-Wythe School of Law.

So, Professor, we are glad you are here. As a Pennsylvanian, I am particularly honored to have the chance to introduce you. Thanks very much.

The CHAIRMAN. Thank you, Senator.

We will now turn to Ms. Markman. You will be first here today.

STATEMENT OF CAROL MARKMAN, CERTIFIED PUBLIC ACCOUNTANT AND DIRECTOR OF TAXATION, EP CAINE AND ASSOCIATES CPA, LLC, WESTBURY, NY

Ms. MARKMAN. Good morning. As Senator Hatch said, I am Carol Markman. I bet you could tell. For over 35 years, I have specialized in taxation of individuals and small businesses. I currently serve, as he said, on the Tax Executive Committee of the AICPA, and I served as chair of the Tax Committee of the National Conference of CPA Practitioners for many years.

Accompanying me this morning is Stephen Mankowski, the current chair of the Tax Policy Committee for NCCPAP. Thank you for the invitation to speak at this hearing on simplification and tax reform.

Simplicity is a lofty goal in tax reform that many of us would like to see. I have chosen to speak about tax simplification related to four areas: retirement plans, education incentives, modified adjusted gross income, and allowable mileage rates.

With regard to retirement plans, there are many types of retirement plans; the IRS website lists 15. Many taxpayers have more than one type of plan when they reach 70½ and must begin taking required minimum distributions from all of their retirement plans.

One area of tax law that I think is ripe for simplification is the rule requiring the taxpayer to withdraw a required minimum distribution from each type of retirement account. This begs the question: why is it necessary to take a required minimum distribution from each type of retirement account? Allowing taxpayers to take their entire required minimum distribution all from one type of plan creates simplicity with no reduction in tax revenue.

Another issue regarding retirement plans is the 10-percent penalty on early withdrawal from a plan. There are 12 different exceptions to the additional tax on distributions before age 59½; however, different exceptions to the penalty apply to different types of retirement plans. It is my recommendation that the penalty excep-

tions to the additional tax on early distributions from retirement plans be made uniform across all types of plans.

As Senator Wyden said, there are many incentives in the tax law related to education which have different income phase-outs, different limits on the number of years that benefit is available, the number of courses the student must take, what types of expenses qualify for the incentive, among others. Many of the benefits are per family rather than per student, which can be a significant issue for families with more than one child in college at the same time. The phase-out of benefits for high-income taxpayers should be made uniform across all similar incentives, and there should be a separate phase-out for taxpayers filing as head of household.

Currently, these taxpayers file and have the same phase-outs as single taxpayers, but their family financial circumstances are frequently very different. There is a need to coordinate the various education incentives in order to simplify these provisions. A computer should not be needed to determine which education benefit applies and which ones will produce the best result for a taxpayer.

Modified adjusted gross income. There are many definitions of modified adjusted gross income that factor into the preparation of individual tax returns. Modified adjusted gross income is determined by adding back certain items to the individual's adjusted gross income. The difficulty is determining which items of income and deduction are added back.

I have identified 17 add-backs and items not taken into account and two subtractions that are needed for one or more modified adjusted income calculations. The varying definitions greatly add to the complexity of tax return preparation so that it requires a computer to calculate modified adjusted gross income in many cases. It would aid in simplification if modified adjusted gross income for similar provisions could be made uniform.

For example, why are non-taxable Social Security benefits an item that must be considered for Roth IRA contribution but not for a non-deductible traditional IRA contribution when neither type of IRA contribution is tax-deductible?

The last area concerns mileage allowances. There are several allowable mileage rates available to taxpayers claiming deductions in connection with business mileage, mileage to obtain medical care, mileage when moving for a change of employment, and mileage while performing charitable activities. All, except the charity rate, are set annually by the IRS.

The charity rate was set by Congress in 1984 and has not been changed in the last 30 years. Today that rate is significantly lower than the rate for moving and medical care, and taxpayers view this difference as unfair since many more taxpayers can claim mileage for charity than can claim mileage for medical care.

Thank you for the opportunity to present this testimony.

The CHAIRMAN. Well, thank you.

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

The CHAIRMAN. Dr. Desai?

STATEMENT OF MIHIR A. DESAI, Ph.D., MIZUHO FINANCIAL GROUP PROFESSOR OF FINANCE AND PROFESSOR OF LAW, HARVARD UNIVERSITY, CAMBRIDGE, MA

Dr. DESAI. It is a pleasure to appear before you today to discuss tax complexity. Excessive complexity in the tax code has negative redistributive and growth consequences that have only accelerated over time as more and more policy goals are now implemented through the tax system.

My written testimony outlines how administrative and compliance complexity retards efforts of policymakers by reducing uptake, increases the likelihood that tax expenditures lead to windfalls for taxpayers rather than to desired changes in behavior, and redistributes wealth towards sophisticated taxpayers and tax advisors who can manage this complexity. Today I would like to emphasize how complexity arises and how to address it.

Complexity arises from a call-and-response pattern of tax planning by practitioners that provokes more detailed bright line rules by administrators that in turn trigger new tax planning opportunities, and so on. This death spiral of planning regulation complexity is evidenced in the most important area of business taxes, international tax rules, where complex rules govern an unwieldy system that raises little revenue.

As a recent example of this dynamic, last year's Treasury notice, designed to prevent inversion transactions, will have the primary effect of transferring wealth to foreign multinational firms and those firms that inverted prior to the proposed regulations, as they have become advantaged acquirers of U.S. assets.

Indeed, several years of anti-inversion legislation and rules have only served to increase the planning activities around mergers and the real distortions undertaken to achieve tax savings. Recent proposals to enact an Alternative Minimum Tax on foreign-source income within a proposed territorial regime provide the latest example of the vices of this planning complexity dynamic.

Such proposals attempt to prevent planning by implementing a de facto worldwide system of taxation without deferral at, for example, a 19-percent rate on a per-country basis, but label it a territorial regime. It would be preferred to explicitly repeal deferral within a worldwide regime rather than to enact such a back-door worldwide regime. Much as today's worldwide system that functions as territorial is much worse than a true territorial regime.

Such complexity creates numerous opportunities for planners who have resources that far eclipse the ability of the government to police them, and their efforts will trigger a new round of regulations with further distortions and more planning opportunities.

A simple territorial system, as implemented by governments around the world with anti-abuse provisions and a simple adjustment to address expense allocation, provides the best alternative to ensure that the corporate tax system advances, rather than retards, the interests of American workers and firms.

Addressing complexity in the tax code requires analogizing to other complex systems and drawing on the research that demonstrates how to manage that complexity. In short, the complexity of the tax code could be managed much as the complexity of software code is managed.

This analogy yields two primary lessons. First, "over the wall" engineering is highly problematic, and concurrent engineering is preferred. Throwing completed ideas over the wall to the next part of a production process limits learning and engenders complexity relative to a concurrent and iterative production process.

Currently, policy ideas are often developed without a clear vision of the associated language and with even less attention to the prospective administrators. The practice of policy formulation and drafting must be a collaborative activity with the administrative agency in charge of enforcement. More consistently following and strengthening the recommendations in sections 402(1) and 402(2) of the Internal Revenue Service Restructuring and Reform Act would provide for a considerable bulwark against creeping complexity by preventing over-the-wall engineering.

Second and more radically, we could embark on an effort to open up the administrative and legislative process in order to effectively "crowdsource" the code. Currently, the code, to the degree its complexity is managed at all, is managed much as it was 50 years ago, in a fundamentally closed manner. Laws and administrative guidance are drafted by small groups in a non-transparent way that pays little attention to the overall architecture of the tax system. As a consequence, vested interests influence the management of complexity toward their advantage, and complexity grows by ignoring interrelationships.

Effective management of complex codes, be it Linux or the tax code, requires three steps. First, a code must be mapped so that all the interrelationships, technically and conceptually, of the different parts of the code become manifest; second, the mapping enables modularization; and then finally, modularization provides the foundation for opening up the code to experts throughout society who contribute suggestions for rationalization and simplification.

By mapping, modularizing, and opening the code and associated guidance, we could draw upon widespread expertise, provide transparency on the critical process, address the imbalance of resources between the taxing authority and sophisticated taxpayers, and begin the process of simplifying the code and the associated administrative guidance. A modest manifestation of the power of crowdsourcing ideas on the code is provided in Appendix A, which compiles the suggestions of 20 experts on complexity.

Finally, three structural features of our tax system most contribute to complexity. First, consumption taxes have major simplification advantages over income taxes, as the base is more readily identified, particularly given the growing importance of cross-border flows of intellectual property. Second, the reliance on realization events engenders great complexity that could be alleviated by considering accrual taxation in some settings. Third, the reluctance to embrace solutions that provide taxpayers with the information that taxpayer authorities already have, as with Ready-Returns, is a major cause of unnecessary complexity in the individual arena. Structural reforms that address these issues would allow for considerable simplification.

I look forward to your efforts in this important area, and I would be delighted to answer your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Desai appears in the appendix.]
The CHAIRMAN. Mr. Bartlett?

STATEMENT OF BRUCE BARTLETT, FORMER DEPUTY ASSISTANT SECRETARY FOR ECONOMIC POLICY (1988–1993), DEPARTMENT OF THE TREASURY, GREAT FALLS, VA

Mr. BARTLETT. Thank you for the opportunity to testify once again before this committee. Senator Grassley was the first one to invite me here more than 30 years ago.

I speak not as a tax practitioner or as an academic, but really more as an observer and occasional participant in the tax legislative process, so I am just going to make some general comments about the sources of complexity. One of them is my observation that a lot of complexity is driven by the need to get the tax distribution tables to look right.

Although I do not think it is a law or regulation or anything, it is just sort of generally understood that if one group is getting too much or too little, at the end of the day you have to fix it somehow. Sometimes that requires coming up with very convoluted ways of very narrowly targeting a tax benefit or a tax penalty to some narrowly defined income group. I do not know what to do about this. It is simply one of the reasons why we have things like PEP and Pease.

Another point is that, just because people do not pay any income taxes does not mean that they, per se, have a simpler tax system to deal with than other people. The reason I bring this up is because, when the 1986 Act was passed, President Reagan was among those who hailed it for its simplicity. His main point of data was, well, we are removing millions of people from the tax rolls, therefore it is, per se, simpler for them. I do not think that is the case for people who have to deal with the EITC, which I gather Mr. Fogg will talk about.

Another thing is, I think when we talk about simplicity, we talk a bit too much about the complexity of the deductions and credits and things like that, but of course a lot of people use the standard deduction or they have very simple deductions. The growing complexity in the tax code or the tax process from the point of view of the taxpayer, it seems to me, is coming from the changing nature of the economy, which is changing the nature of income.

More and more workers who used to get a simple salary are now in effect independent contractors—Uber drivers, for example—who are in effect small businessmen who now have all of the complexity that goes with running a small business: keeping track of all the records of expenses, having to depreciate property, perhaps, and things of this sort that make what appears to be a simple calculation of income actually rather complex. This is a problem I have to deal with in my own personal situation, which is why, for decades, I have had to pay a tax preparer and cannot do my own taxes.

I would agree with Professor Desai that some type of consumption-based tax system has at least the potential of simplifying our tax system. I know that Senator Cardin has introduced a bill to do something along those lines. I gather it is based on the proposal

that Professor Gratz at Columbia has put together. I am very sympathetic to that.

It deals with a lot of the political problems of moving towards a simpler tax system by simply making so much of the tax system irrelevant for a large portion of taxpayers who would simply pay their taxes by buying things. But this would require putting in a value-added tax. I am well-aware of the hostility to that in certain quarters, and I am certainly sympathetic to that, but I think it is something we at least need to talk about, because I think someday we are going to have to deal with it.

I think in common conversation much, too much is made out of the idea of trying to get to a single-rate tax system. I think I testified before this committee around 1995 in favor of the flat tax. I now think that it is not necessary to have a single rate to achieve simplicity. I think the simplicity that that achieves is grossly overestimated. Like I said, I think the growing problem is more in terms of determining income.

Let me just say I think that doing major tax reform, tearing the tax system out by its roots and starting from scratch, has an enormous amount of attraction. But I think that in many cases it prevents us from doing stuff which is doable now to just fix glaring problems in the tax code, which I am sure the other witnesses will discuss. I just fear that we are constantly putting off doing what is doable on a bipartisan basis because we are holding that off to use for fundamental tax reform.

I have a few other points I made in my testimony, but I will stop there. Thank you, Senator.

The CHAIRMAN. Thank you.

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

The CHAIRMAN. Mr. Fogg?

STATEMENT OF T. KEITH FOGG, PROFESSOR OF LAW AND DIRECTOR, FEDERAL TAX CLINIC, VILLANOVA UNIVERSITY SCHOOL OF LAW, VILLANOVA, PA

Mr. FOGG. Thank you very much for inviting me to speak on behalf of low-income taxpayers on how to make the system simpler for them. I want to use a new client that I have to illustrate how the tax system itself is complex for low-income taxpayers. She is a woman of limited English proficiency. She works in the health care industry and works through a temp agency.

She met someone there while waiting to be assigned for a job who told her she would help with the filing of her tax return, so this friend took my client to a tax return preparer. The tax return preparer took her information, had her sign a form that shielded her from seeing the information on the document, but told her that she would get a refund of approximately $1,000 and it would come in a few weeks.

In a few weeks she had not received her refund. She could no longer find the friend, and she could no longer find the return preparer. After a few more weeks, she began to reach out to the Internal Revenue Service to find out about her refund, eventually finding out from the Internal Revenue Service that a refund of $7,000 had been issued some weeks earlier.

At that point she went into a panic, which was logical, and found another preparer. This preparer prepared an amended return for her, properly claiming a $1,000 refund, but unfortunately improperly using the amended return to do that.

Eventually the Internal Revenue Service began to match the information from third parties with the documents that were available on her return and determined that the return that was filed was not entitled to a $7,000 refund. She got letters eventually leading to her being assessed, eventually leading her into the collection process, and eventually leading her to our clinic.

But at this point in time, a woman who only makes around $13,000 a year has not received her $1,000 refund for 2013. We are advising her not to file her 2014 return because it will just be taken to offset the liability now assessed against her for 2013, and it is going to take a lot of work on the part of my clinic and on the part of the IRS to correct this problem.

I want to talk about simplification in the return filing process as a way to avoid this problem for many low-income taxpayers. In our 2014 annual report, the National Taxpayer Advocate, using statistical profiles of low-income taxpayers, came up with findings that are not shocking, that they generally have lower education, many have low English proficiency, many are disabled, and many are elderly. These are the types of people that my clinic deals with every day, and these are the types of people who are having to encounter the tax system many times because, 20 years ago, we decided to deliver benefits through that system, through the Earned Income Tax Credit.

So I want you to think about how the Earned Income Tax Credit works and how refundable credit works in thinking about how low-income taxpayers must interface with this system. Because, while the Earned Income Tax Credit provides tremendous and important benefits to low-income taxpayers and provides a platform for efficient delivery of that, it also thrusts them into a tax system which is very difficult for them to navigate.

Low-income taxpayers typically have significant communication problems. My students have a lot of trouble getting through to them. You can imagine the difficulties that they have when trying to get through to the Internal Revenue Service phone lines, which are tied up. My clients are generally working during the day. They do not have easy access to phones. A lot of them have TracFones, and, if they call the IRS, they will use all of their minutes for the month just waiting on hold.

There are very few walk-in sites now, so they cannot do the in-person communication that they would prefer to do. The IRS, because of staffing issues, is moving more and more to the Internet. The Internet does not serve my clients well because they are not able to process information through the Internet the way that you and I could.

So the answer to this, for me, is to focus on getting the return filing right, to stop focusing on getting the refund out quickly and move to a situation with returns where the IRS loads the third-party data before it processes the returns. Bringing this back to my client, if that data had been loaded before the return was processed, there never would have been a $7,000 refund issued, the IRS

would not be out $7,000, my client would not have a $7,000 tax bill the IRS is trying to collect, and we would simply be dealing with trying to get her the $1,000 that she deserves.

Also engaged with this, and I know there are bills out there dealing with this, is regulating return preparers. The low-income taxpayers are the ones who generally fall prey to the poorer return preparers, and I think that regulating them would be a way to enhance the ability of low-income taxpayers to properly get representation in their one touch with the system. So we are very, very interested in that, and providing a way for the IRS to provide walk-in assistance to taxpayers, because they want that personal touch.

Thank you very much for allowing me to testify.

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

The CHAIRMAN. Thank you. We appreciate all four of you being here today.

Let me start with you, Ms. Markman. Your firm represents clients in higher cost of living urban and suburban areas. Many families in these areas have incomes that would make them appear to have high income in many parts of the country, many other parts. Because of the higher cost of living these families face, they are probably closer to middle-income or maybe even upper middle-income situations. The higher costs of living are particularly evident in larger mortgages and higher State and local taxes.

Now, those expenses tend to translate to itemized deductions. Back in 2001, you were quite clear about the rules that were in effect, the so-called Pease cut-backs, and the complexity these hidden marginal rates brought to your clients. In late 2012, the Nation confronted, as we all know, the fiscal cliff, and, as a price for a fiscal cliff agreement, the White House and its allies in Congress insisted on bringing back these rules for single taxpayers at $250,000 and families at $300,000. These income levels are national. They do not adjust for cost of living variations among States and regions.

Now, Ms. Markman, for complex rules like the cut-back on itemized deductions with its disproportionate impact in high cost of living areas, isn't the best adjustment to eliminate these rules? Can you see any justification for complex rules that can hide marginal rates that zero in on folks in these high-cost urban areas?

Ms. MARKMAN. Pease and PEP exclusions make taxpayers very angry. They have children, they have, as you said, real estate taxes, mortgage interest. These are things that they know the rule book says they are allowed to deduct, and yet, when we go to prepare the tax returns, they are frequently phased out of the opportunity to obtain the benefit of up to 80 percent of their itemized deductions and frequently lose the benefit of all of their exemptions.

There is an anger factor there. I mean, they understand that this is how the law was designed, but the question is, well, how did we get along without it for that period of time and why was it brought back? You cannot explain that to a taxpayer. All they know is that there is a benefit that appears to be for them and yet they cannot use it.

Real estate taxes of $15,000 and $20,000 are quite common where I practice. People have large mortgages because houses are very expensive. The people who are significantly burdened as well

are those with large numbers of children. There is no taking account for that. So from my perspective, and I think from the clients' perspective, they would much prefer to see a rate that is clear, that is transparent, rather than the stealth rate because of these phase-outs.

Also, they ask me, what is my marginal tax rate? The answer is, you cannot tell them because there are the phase-outs. Phase-outs are frequently on top of other phase-outs. For instance, medical is phased out for most people at 10 percent, except if they are older than 65, and then it is at 7.5 percent.

Miscellaneous itemized deductions are phased out at 2 percent of adjusted gross income. So it is like piling things one on top of the other. I think that is a simplification that is definitely worthy of consideration.

The CHAIRMAN. Well, thank you.

Dr. Desai, you stated in your testimony that last year's Treasury Department guidance on inversions and several years of anti-inversion legislation and rules "have only served to increase the planning activities around mergers and the real distortions undertaken to achieve tax savings." In that vein, you referred to these rules and regulations in the context of the "death spiral of planning regulation complexity."

Now, I am very concerned that the path the administration is taking on international tax changes, particularly with the imposition of an anti-competitive 19-percent minimum tax, will only continue this death spiral, particularly in the context of inversions, as more U.S. companies make plans to invert and Treasury releases more regulations and guidance to prevent it.

Now, if the United States were to adopt the international tax proposals, in particular the 19-percent minimum tax included in the President's latest budget, do you foresee an uptick in planning regulation complexity due to the increased desire by U.S. firms to invert, and what is the best path forward to prevent this death spiral of planning regulation complexity in the inversion context, and will a territorial type of tax system help? That is a lot of questions.

Dr. DESAI. Well, I will take my best shot. So I think there are several things to say. First is to realize that, in this setting, there is a great mismatch between the abilities of the IRS and the taxpayer, so these corporations are very sophisticated. They are going to invest huge resources to achieve their goals.

So one should always keep an eye on that when one is designing international tax rules, because there is a fundamental mismatch in resources, which is not true across all the different taxpayers we are talking about.

So the second thing to say about the minimum tax is to make sure we understand it as what it is, which is repealing deferral in a worldwide system. That is what it is. I think what is difficult about the proposals is that they label it territoriality but effectively they are repealing deferral.

The CHAIRMAN. Right.

Dr. DESAI. So we should understand first off that that is what it is, it is a worldwide system with a repeal of deferral at a 19 percent rate.

Then the third thing to say about that is to just realize that that decision to go in that direction is fundamentally at odds with the way the rest of the world has gone in the last several years. And as a consequence of that, it becomes very difficult to become an American acquirer of U.S. assets, it becomes difficult to become an American acquirer of foreign assets, and it becomes very nice to be a foreign acquirer of American assets.

So that is the fundamental nature of what that trade-off yields. That, in turn, is problematic, because American companies, when they expand abroad, tend to expand domestically. American managers who belong to American companies do well when their firms expand abroad. American workers who are part of multinational firms that grow abroad are going to benefit from that, so fundamentally it works against all those.

What would I expect to see if that were to happen? I would expect to see more of what we see now, which is not inversions in a pure sense but something maybe much more destructive, which is, (A) multinational firms making themselves smaller by splitting so that they can be acquired by foreign companies. Under the recent regulations, in short, you need to get smaller so that you can be bought up by someone else, because that is the way the rules work—a very perverse consequence.

Then, second, you can expect more foreign buyers and the people who got in under the gate of September, whatever it was, to become really good acquirers of companies. That all is unfortunate. So I think the way forward is somewhat straightforward. The way forward is to think about a simple territorial regime, a real territorial regime as enacted around the world, which has a rate that you apply to domestic income but then tries to get at expense allocation and abuse in traditional ways, as opposed to what is effectively a back-door way of doing it.

The CHAIRMAN. Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman. This has been an excellent panel. I am, Dr. Desai, going to pass on the temptation to get into the territorial issue because I want to see if we can find some common ground as it relates to individuals.

Now, last week I put out a report here in the Finance Committee that looked at some of the most recent and some of the most offensive of the tax loopholes. We looked at wash sales and option collars and swap contracts.

Suffice it to say, there is kind of a bundle of these tax provisions that eliminate a substantial amount of investment risk, and the people who can take advantage of it pay half the tax rate. That is pretty much what goes on. They pay half the tax rate of people who just punch a time clock every day and have their taxes automatically taken out of their paychecks.

So at that point it seems to me there is a disparity in terms of fairness. In other words, the middle-class person just has it taken out of their paycheck, and, if you are able to hire all these sophisticated tax pros, you can take advantage of the things that I described in the report.

But in addition to the disparity in fairness, there are other problems, because what happens as a result of sophisticated pros being involved and trying to use every possible tax shelter is, we end up

with a whole lot of additional tax complexity, because the Treasury Department says, oh my goodness, we have to limit all these shelters and all the damage that they are doing. So then we have more complexity and more expense associated with trying to deal with these shelters.

Yet, despite the shelters, what my report found was that sophisticated taxpayers with all these pros can still game the system, and this costs the Treasury billions and billions of dollars.

So my question is as follows. Maybe I will just go right down the row, starting with you, Mr. Fogg, but I would like to get everybody. A few weeks ago, sitting where all of you are, was a Republican and a Democrat. They were the architects of the 1986 tax reform bill. In the 1986 tax reform bill, they equalized tax rates for income from wages and income from investments. They said, you ought to do it again. They said it made sense in 1986, and it makes sense now.

The question I have for each of you is, and let me just maybe go right down the row, how much of this tax compliance and enforcement headache and complexity and time and money, how much of it, in your view, would in effect diminish or maybe even go away in some particulars if we said in America, like a group of Democrats and a group of Republicans did in 1986, we are going to make the tax rate the same for income from wages and income from investments?

Let us just go down the row. Just an opinion about complexity. I know we will have people having differences of opinion on the merits, but just an opinion on the complexity. Would it be less of a headache, less of a compliance burden? Let us go down the row: Mr. Fogg, Mr. Bartlett, the rest of you.

Mr. FOGG. All right. You know that for low-income taxpayers it is not much of an issue, the difference. They do not have much in the way of investments. But I think that you could reduce complexity by making the rates the same for both. I know there are reasons not to do that, but yes, I would agree with that as a general principle.

Senator WYDEN. Good.

Mr. Bartlett?

Mr. BARTLETT. The big problem with capital gains is that the taxpayer chooses when, or if, to realize that income. So income from capital gains and from ordinary income are not symmetrical. This is the historic problem with capital gains dating back to the 1920s: if you raise the rate on capital gains to the ordinary income rate, people will simply not realize capital gains, and you have what is called the lock-in effect. This is the reason why, historically, there has always been a lower preferential rate on capital gains.

Now, I think this is a very serious problem, this realization principle that I think would be desirable to get rid of if there was some way to do this. The way they do it in Europe, in some countries, is they have what is called a dual income tax, where they have income that goes into what they call boxes.

The one system I have looked at is, I believe, the Netherlands, where capital gains all go into a particular box and they assume an imputed rate of return on which you pay taxes. But it is com-

pletely unrelated to whether you realize gains or not, so you can buy and sell all you want to without having to worry about whether you are realizing taxable capital gains. I think trying to do something along those lines might be the way out of the problem of the fact that capital gains are just fundamentally different from ordinary income.

Senator WYDEN. Dr. Desai?

Dr. DESAI. I think you are absolutely right, Senator Wyden, to focus on these issues. I think they are paramount to understanding complexity. Of course, the most major manifestation of that is the way carried interest is treated generally.

I would say about a third of it is the disparate rates, and I think two-thirds of it is the realization doctrine that I mentioned in my testimony as well. So those are the two fundamental roots of it, and I think the lion's share of it is coming from the realization principle.

Ms. MARKMAN. The 1986 Act did create simplicity, but at what expense? It introduced the whole concept of passive activities and passive activity losses and greatly impacted at the time the entire real estate industry, which we saw very clearly subsequent to 1986, where real estate became this bad activity because, if you did not actively participate in it, then you were not entitled to claim your losses.

The losses were real, but you could not claim them because they were considered passive activities if you were not actively engaged in it. So there was a price to pay, and it created its own element of complexity. Also, the carried interest rule. Why is carried interest considered capital gains today? That does not make any sense from where I sit.

The other thing that I think is an unfairness and looks at the whole issue is the 1031 gain issue, that you can postpone the gain on the sale of property simply because you reinvested it in other property, but only if it is business property. I mean, there are a whole bunch of issues there that I think create another level of complexity.

Senator WYDEN. My time has expired. I just want, on the point you made with respect to real estate, I can tell you a bipartisan majority here on the Finance Committee does not believe investment in real estate is evil, and you can see that by the bill that we just passed, the Real Estate Investment and Jobs Act.

Ms. MARKMAN. I am saying that that was the result of the 1986 Tax Act.

Senator WYDEN. Well, there are a lot of Senators here who have gotten the drift.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Carper?

Senator CARPER. I think Senator Casey might have been here sooner, so, if that is the case, I should yield. I want to stay on his good side.

The CHAIRMAN. That is not what I have, but I would be happy to go to Senator Casey.

Senator CARPER. Thank you, though.

Senator CASEY. Well, thanks, Senator Carper. I am not sure what I owe him now, but I am sure it will be something substantial. [Laughter.]

Mr. Chairman, thank you and the ranking member for having this hearing. I want to thank our witnesses for your appearance here and your testimony, as well as helping us better understand these issues.

In particular, Professor Fogg, I want to focus on some questions that you have raised, and in particular I also wanted to thank you for the example you provided in your testimony. Sometimes it is best to tell the stories or to illustrate these problems or challenges through the story of a real person and the folks who do not have economic power, who are sometimes not able to navigate the tax code as some others who have greater means.

I wanted to focus, first, on what is a difficult tension, I guess: the tension between making sure the refunds go out as quickly as possible versus making sure that the IRS can do its job to identify instances of fraud.

On the one hand, delaying refunds could help the IRS identify those examples of fraud before issuing refunds, and, on the other hand, delaying is disruptive to that individual who may have to pay, as you cite in your testimony, a utility bill or some other immediate need in their life.

So I wanted to focus in a particular way on some of the recommendations that you made to mitigate the impact of delaying refunds on tax returns. If you could just kind of walk through some ways to mitigate that problem.

Mr. FOGG. I think that, for the most part, it may be a one-time problem. I mean, we have created a system where people expect their refunds early in February. I mean, particularly for people who have a large refund who are at the door when the IRS opens the door for tax returns, they are filing and they are hoping for a refund very quickly in February.

We have a lot of industries that are pegged toward those people getting refunds then. I think utilities is one where we really have to think about it and work it out, because the money is coming at a time when many of my clients need the money to pay their heating bills. So there has to be some way to work with the utility companies. That kind of bill is one that is being postponed until a critical point and needs to be paid, and I understand the difficulties that it will create for my clients if you delay.

Once you delay in the first year, we have just created a different cycle for people to deal with on taxes. I mean, we almost have this Circadian rhythm of where we are today, but it does not have to be that way. I mean, it could be that we get used to getting our refunds in April or May rather than in February and March.

What I am suggesting is that, to make the system work for low-income taxpayers and not cause them to get caught up in the back end of the system, if the IRS could get the data quicker, load the data, and have it when people are filing their returns, they will be able to determine which returns are bad. I think that will drive the identity thieves and the fraudulent preparers out of the system, because they will no longer be able to get the money as quickly and easily as they get it today.

Senator CASEY. I guess, if you had to do a profile of your typical client, what is that basic profile, the low-income clients that you have?

Mr. FOGG. About half of my clients who are coming in are dealing with the IRS on whether they owe the tax, and about half of my clients already do owe the tax when they come to me, so we are dealing with how to deal with the IRS on the payment of the tax.

So, if I am looking at my client and we are determining whether they owe it, it is frequently an elderly couple or elderly individual or a single mother who has children whom she is dealing with and has claimed the Earned Income Tax Credit.

If the Earned Income Tax Credit is involved, it is frequently somebody who has claimed the credit and been denied, probably because the dependents have been claimed by someone else, and that other person claiming the dependents may have claimed first.

Right now there is a race to file your tax return because the first person in gets the refund for that child, so, if you are the second person in, you get denied and you have to then work through the whole back end of the IRS system. So that client is the one whom I am concerned about, because frequently my client is not the first one in, they are second in, so they are being tossed into the IRS compliance system, all because somebody wrongfully claimed the child before they did.

So that is a typical client. So they are not getting their refund, which could be $6,000 or $7,000, which could be a third of their income for the year, and then they may not get it for a couple of years by the time they fight through the IRS system, not that the IRS is doing anything wrong, but that is just the way the compliance system works once you are caught up in the system of having to fight over your refund. And, if you end up in court, it takes even longer.

Senator CASEY. Thank you very much. Other members of the panel, thank you.

The CHAIRMAN. Thank you, Senator.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. Thank you, panelists. I have been to several other hearings, Mr. Chairman, and I have always wanted to ask this question but time has not allowed. So I am not even sure that you are the right panel for this question, but if people want to weigh in——

My general question, and then I have a specific question for Mr. Bartlett, is just, when I look at our discussion of tax reform, and so much is centered around the competitiveness of industry as it relates to what is happening on a global basis and the fact that they have to reduce their corporate rate, I look at it and say, isn't the bigger issue that we are in an innovation economy, and what is the best tax code to take advantage of that innovation economy, to make the right investments, and to grow the opportunity within that innovation economy?

Dr. Desai, I guess I kind of like your software approach to the tax code and your suggestions, because at least you are thinking about some of the advantages there as it relates to that.

So my question, the broad question, if anybody wants to weigh in on it, is just, shouldn't we be thinking about this as it relates to the growth opportunity in GDP and how we best harness that growth opportunity? So having a tax code that basically fits an innovation economy and takes advantage of it is what it is going to take for us to compete, which again means investing in research and development and the skill level of the workforce and what have you.

One of the very specific issues, though, Mr. Bartlett—and I have read your books, and thank you for all your columns. I think it has been very helpful to have this kind of discussion in the broad public. I wish we could do more of it. I do not know if that means you are writing another book in the future, but certainly I would sign up to read it.

But is this issue of where we are with retirement savings and annuities—I just feel that we are so far behind with where the public needs to be in savings. We have looked at having annuity legislation here as a way to further incent people making investments in their retirement that would pay out at a better scheme. So specifically about annuities in an innovation economy——

Mr. BARTLETT. Well, as you know, for quite some years, at least since 1978 when the Keogh plan was invented, we have been transitioning from a defined benefit-type system to a defined contribution-type system, and more and more the burden of retirement saving is simply on the individual.

Certainly anything that can help people prepare for retirement is all to the good. I am not sure precisely how that relates specifically to an innovation economy, except insofar as I pointed out earlier that more and more people are being forced to become independent contractors in our economy.

One of the benefits, frankly, of being an independent is that you have more options available for retirement savings and, to a certain extent, tax sheltering of those savings. But entrepreneurial incomes vary, and people may be forced to take money out of retirement accounts and get into the whole penalty situation.

The one thing I would mention specifically with regard to innovation is to please make the R&D credit permanent. See, it does not actually do any good the way it exists because, if you are making and planning an investment in technology that would qualify for the credit, you are probably planning years down the road, and your accountant is going to say, we cannot build that in to the rate of return because we are not sure it is going to be there down the road when we would have the investment that we would claim the credit for.

So it just ends up being a reward for things that companies would do anyway, so what you have to do if you want it to work to increase net new incremental investment is, you have to make it permanent.

Senator CANTWELL. Thank you.

Dr. Desai?

Dr. DESAI. I was just going to mention briefly, I think you are absolutely right to focus on this. I think if you were thinking about this, you would think about three things. The first is underlying sources of innovation. You have to think about education, and so

you would want to think about education incentives which are massively complex and under-utilized. Second, you would want to think about the R&D tax credit and making it simpler and permanent. Then the third thing on the international scene is, as you may be aware, everybody wants R&D. Everybody wants this, so countries have gotten very aggressive, and now they have patent boxes, which are effectively a little specialized tax regime for intellectual property. So, come to our country, put your patent there and put some scientists there, and we will give you a really low rate, like 5 or 10 percent. So I think that should inform our broader corporate tax debate, because these countries are getting patent boxes for exactly the reason you want, which is, they are for R&D. So our system has to be something that at least provides an alternative that is as good as that.

Senator CANTWELL. Well, we have had some testimony on this, and I think we have to expound on it more, what other countries are doing with their patent boxes. But thank God, innovation is in the American DNA and cannot be easily transferred, as much as other countries want to. But you still have to put the input into education and job training and all the things that go along with that innovation.

Thank you. Thank you, Mr. Chairman.

Senator Thune [presiding]. Thank you, Senator Cantwell.

Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman. Let me thank all the witnesses today. Mr. Bartlett, thank you for your comments on the progressive consumption tax. At the last hearing, we were dealing with fairness, and I went through how we could get better fairness in tax reform and went through the advantages of a progressive consumption tax. This is on simplification. We could talk about competitiveness, trying to get marginal rates that are competitive globally. As long as we rely solely on income taxes, we will never get competitive marginal rates on the international front.

Or we could talk about rewarding savings, because America, even in the best economic times, had low savings ratios, and in some cases we had negative savings ratios during periods of economic expansion. A consumption tax rewards savings. Or we could talk about international trade and the rules of the WTO and what is border-adjusted.

But I want to get your response on the simplification issues and the advantages of moving away from solely income taxes or primarily income taxes to looking at a progressive consumption tax. I want to focus on a couple specific points. One, it seems to me it is easier to identify consumption than it is income. One of the issues on simplicity is that people want to know that they can figure out their tax liability.

So the first issue I would just like you to concentrate on is, on the matter of simplification, wouldn't we be better off using an entity for taxation that is easier to define, such as consumption, rather than income?

The second point, and then I will give you a chance to respond to this, is that, in the proposal that I brought forward, you have a lot fewer taxpayers. There is no income tax liability for families with taxable income below $100,000. That eliminates a lot of your

income tax returns, certainly simplifying things. Of course, far fewer people pay consumption taxes, collected consumption taxes, so you get fewer taxpayers.

The third is that we simplify the personal income tax by having only four major deductions from it for State and local taxes, charitable contributions, interest on mortgages, and benefits that employers pay.

So concentrating on simplification, because that is today's hearing topic, I would like to get your reply as to whether you think that moving towards a consumption tax would in fact simplify the tax code from the point of view of American taxpayers, and whether you believe we should be moving in that direction. I will start with Mr. Bartlett.

Mr. BARTLETT. Well, certainly having a consumption tax offers the potential of massive simplification. You could eliminate a lot of people from not merely having to pay taxes, but having to even keep any records. The problem we have always had is that the term "value-added tax" always comes up as soon as you bring this issue up, and that is considered the devil's work, or something, I do not know. There are a lot of people who are just very afraid of that term.

Senator CARDIN. A lot of people are afraid of taxes too.

Mr. BARTLETT. Well, that is true too. But there is a school of thought that some economists have, which is that it is good to make tax-paying as difficult and painful as possible because, that way, there will be a political incentive to keep the tax burden down. I think that is ludicrous, but there are people who have written articles in respected academic journals making that point.

I would just say that every other major country has a national consumption tax of some kind. We are the only one that does not. Having that as a revenue source would potentially—we could do so much simplification with that. We could eliminate deductions and credits and reduce rates and make tax credits like the R&D credit permanent. There is enough revenue there. The last time I thought about it, you could get something like $50 billion a year per percentage point from a broad-based value-added tax.

One of the great things about it is that it improves competitiveness, because the corporate income tax is not rebatable at the border, as you know, and the value-added tax is. If we replaced the non-rebatable tax with a rebatable tax, that, per se, improves competitiveness. There are just so many good arguments for it, it is sad that we cannot have——

Senator CARDIN. I just want to point out that the bill that we filed uses a credit method so that you get full credits for all the taxes that you have paid in the production chain, so you get uniformity of collection, but you also get fairness from the point of view of what you have to pay and do not double pay.

My time has run out, but I see that you are anxious, so please.

Ms. MARKMAN. The sales tax is a very simple consumption tax, but it is the most regressive tax because it affects people least able to pay.

Senator CARDIN. If you use——

Ms. MARKMAN. You have to craft it——

Senator CARDIN. Just so you understand, the bill that I filed provides credits for low-income families based upon size and income. So you have a card that you use, as we currently have for certain government benefits. You would use that card as you purchased your item, so if you had low income or a certain family size, you would not pay the consumption tax.

Ms. MARKMAN. Would it affect what people decide to do? If you had two people who were single, would they decide not to get married because they would then be affected by this income threshold that you would have created where, above that, they would be subject to the tax? I mean, there are a lot of societal issues.

Senator CARDIN. That is a good question on marriage advantages or penalties. I know we have that under our current tax code. Your status is much more determinative of your income tax liability than it would be your sales tax liability. It is very difficult to avoid consumption. You can manipulate income, but you cannot manipulate consumption.

Ms. MARKMAN. To a certain extent. You can choose not to buy, however.

Senator CARDIN. Sure.

Thank you, Mr. Chairman.

Senator THUNE. Thank you, Senator Cardin.

Senator Brown?

Senator BROWN. Thank you, Mr. Chairman. Thanks to Senator Hatch and Senator Wyden for holding this hearing.

Mr. Bartlett, I would like to ask you a couple of questions. You testified that it is especially hard to cut tax rates without disproportionately benefitting the wealthiest taxpayers. It calls into question the wisdom of continuing to chase comprehensive tax reform modeled after 1986.

In my mind, there seem to be two alternatives. The first is to wait until the political dynamics change and we can explore new sources of revenue. The more preferable, I think, of the two alternatives and the more realistic possibility is that we abandon this quest to recreate comprehensive tax reform and instead focus on a set of discrete packages of reform.

I think the chairman's request and follow-through with Senator Wyden on setting up these five or six working groups with one Republican, one Democrat sort of co-chairing them as a forum for teeing up this kind of reform, particularly in the areas of international corporate taxes and retirement savings, is a good start.

Mr. Bartlett, if you would, walk through how a piecemeal path to reform could work in your mind and offer your thoughts and advice on how we proceed.

Mr. BARTLETT. Well, let me make a point about the 1986 act, because that is always the guidestar for trying to start with tax reform. The problem with the 1986 Act is that it was basically a tax increase on corporations. That revenue was then used to both simplify and reduce taxes for individuals.

The problem now is that all the political and economic pressure is to cut rates for corporations, but there are not enough deductions or tax expenditures on the corporate side to finance a meaningful reduction in rates just on the corporate side.

So, if you want to get the top rate, the corporate rate, down to, say, 25 percent, which is the number I keep hearing, you have to get some additional revenue from the individual side. So, in effect, you are going to have to raise taxes on individuals to cut taxes for corporations, and I think that is impossible politically.

So that raises, again, the idea of putting a new revenue source on the table that could finance a reduction in the corporate tax rate. I do not know if that answers your question.

Senator BROWN. Well, it answers the first part. But give us more thoughts on how we would sort of do this piecemeal then, where you would like to see us go.

Mr. BARTLETT. Well, it seems to me if you talk about the things that Mr. Fogg, Ms. Markman, and others have discussed, there is a lot of simplification that could be done in a pretty revenue-neutral, or even de minimis revenue fashion. I would like to see that done just to show that it can be done.

I think it has been a long time since there was a big tax reform bill, and I think Congress needs to—there are very few members here left who went through any of those previous processes in 1969, 1976, or 1986. I think you need to crawl or waddle before you can learn to walk, and we have to start somewhere.

Senator BROWN. All right. Thank you.

The President has proposed a 19-percent minimum tax that is not dissimilar to what was proposed by Chairman Camp. Would that proposal reduce complexity? Would it increase complexity, would it reduce compliance, would it increase compliance? Talk that through for us if you would, Mr. Bartlett.

Mr. BARTLETT. Well, Professor Desai is actually the expert on that. I would defer to him.

Senator BROWN. Well, I would like to hear your thoughts first, then his.

Mr. BARTLETT. I honestly do not know whether it would improve simplification, but then again the international side of our tax code is so complicated it is hard to make it more complicated, so it would probably help to some degree.

Senator BROWN. And compliance. Thoughts on compliance, or no?

Mr. BARTLETT. Well, certainly economists assume that the higher the rate is, the more incentive there is to evade or avoid taxation, so lower rates, per se, improve compliance.

Senator BROWN. Dr. Desai?

Dr. DESAI. I was just going to mention briefly, I think if one has that policy goal, then one should just stay in a worldwide regime and repeal deferral, and then compliance could be better. Whether that is actually in the interest of the country is a different question, and, as my testimony suggests, I do not think so.

I just wanted to address one other thing about the business side, which is, I think there is revenue, and I think it is largely in the scope of kind of pass-through entities. So if you wanted the revenue on the business side, the place to find it is in the massive growth of pass-through entities and addressing that, because that could actually generate a lot of revenue.

Senator BROWN. All right. Thank you.

Senator THUNE. Thank you, Senator Brown.

Senator Carper?

Senator CARPER. Thank you. Great to see you. Thanks for your testimony.

Mr. Fogg, our youngest son is a William and Mary graduate, a proud William and Mary graduate, so I especially want to give you a warm tribe welcome here. That is from a guy from the Blue Hen State. But it is nice to see you all. Mr. Bartlett, nice to see you again, and others too.

Sometimes when you have a panel of brilliant people like this who do not have the same views on tax simplification, I like to ask, what do you agree on? I think it would be helpful for us as we try to develop consensus. Where do you see some common ground? Because we have to develop that here. Maybe you could help lead us in that direction.

But, Mr. Fogg, where are a couple of areas where you think this panel actually agrees on tax simplification?

Mr. FOGG. We have talked on so many diverse things, I do not know that we have even talked on the same thing. I mean, I think particularly if you go to pass-through entities, for me that appears to be an area where there is a lot of ground that could be made up in collecting revenue. So, I would definitely agree with that comment as a place to look for simplifying and maybe gathering more revenue.

Senator CARPER. All right. Thank you.

Go ahead. If you have another one, go ahead.

Mr. BARTLETT. I think we would all agree that it is a bad idea to have so many different incentives for more or less exactly the same purpose. Retirement and education are two areas that come very much to mind.

Senator CARPER. Why do you suppose we have so many? That is a good point.

Mr. BARTLETT. Well, because somebody gets an idea, they pass a bill, and they want it to be the Cardin bill or the Thune bill, and so they have an incentive to kind of have a proprietary interest in getting their legislation enacted in its own form. The former chairman of this committee, Mr. Roth, has something named after him, the Roth IRA.

Senator CARPER. There is a bridge in Delaware named after him too. I authored that legislation. [Laughter.]

Mr. BARTLETT. So I think sometimes people are just myopic, and, when it comes time to do these things, it is easier to just enact a separate standing bill as is rather than work harder to integrate it into the existing tax system, perhaps. I do not know.

Senator CARPER. All right.

Dr. Desai?

Dr. DESAI. I was just going to mention two things. One is, I think there is broad agreement about unifying, as Bruce suggested, retirement and education. I think that is clear. I think Mr. Fogg's idea about providing information that the government has to taxpayers is brilliant, and I think ReadyReturns is a great example of that.

I think the reason we do not do it is because there are powerful interests who do not like that idea, namely the tax preparation industry. But I think it is a fantastic idea and would help low-income folks, but actually would almost help everyone if the IRS were to

send the information they have to the taxpayer. That would be the foundation of a return.

Senator CARPER. All right. I have been in and out of the room, at other meetings, in the adjoining room. I may have missed that point. I will come back to you and ask you to drill down on that, Mr. Fogg.

Ms. Markman?

Ms. MARKMAN. In light of what we talked about, what Mr. Fogg talked about, the question is, why does W–2 data go to Social Security first and IRS second? Why can't it go to both at the same time? A lot of the problems that his clients have are a result of the IRS not getting the information in a timely manner. It is delayed. Usually the IRS does not get withholding information until late spring or early summer.

New York State has a method where they actually get the information of the State tax withheld by the end of January. There is a quarterly report that, at the end of the year, includes all income that that person earned and all tax that was withheld from that person in State and local taxes.

If that information, similar information, would go to the IRS directly—it is available. The people who prepare payroll tax reports have to have it in order to prepare the W–2s which have to go to the taxpayer at the end of January. The State is able to get it, and therefore they do not have the same kind of identity theft problems that the IRS has, because the people in government in New York, the tax department, will tell you, we look at that report before we issue any refund to anybody.

I think that is something that we should all be able to agree upon: that we need to find this mechanism to have the government, have the IRS, have the information it needs to be able to process returns as quickly as they would like, but with the adequate information to make a proper decision about whether or not the refund in fact is due.

Senator CARPER. All right.

Mr. Chairman, my time has run out. I have another question, if you do not mind. It relates to the first one.

The last time I think we had an analysis of the tax gap, we were told that the size of the tax gap—monies owed for Federal taxes not being collected—was about $385 billion. That was in 2006. I do not know that we have updated it since that time. I have been working on some legislation that would seek to improve compliance, would seek to streamline administration, and would also hopefully reduce our Federal tax gap somewhat.

Even so, targeted proposals to improve compliance will not by themselves address this problem. There are a couple other areas that need to be addressed, and one of those is that we have to provide revenue authorities with sufficient funding for effective enforcement, and the second would be that we need to simplify the tax code, which is what this hearing is all about.

I am going to come back and ask a question kind of similar to my last one, but different. With today's topic in mind of tax simplification, could you all walk us through just maybe one proposal, just one proposal, if you have not done it already, that you believe would not only simplify the tax code but would also simultaneously

improve compliance rates and reduce the tax gap? Mr. Fogg, do you want to lead off? Thank you, Mr. Chairman.

Mr. FOGG. I am probably going to be repetitive.

Senator CARPER. That is all right.

Mr. FOGG. If the IRS has the data before it sends out the refunds, then I think it makes it simpler for the taxpayers. And I think if they send out the data to the taxpayers, I think it makes it even simpler for them to prepare their returns. And you would not have all of the refunds going out that should never have gone out the door, so you do not have to engage in the compliance mechanisms of trying to collect it.

If you are trying to collect it from my clients, it is a losing game for the IRS, because they do not have it. So, once the money goes out the door to low-income taxpayers, unless the IRS can offset it in some subsequent return, it is, for the most part, lost because they do not have a way to collect it, because the taxpayers do not have the money.

So focusing the system on getting it right at the return, making a principle of tax administration that we are going to get it right when people file the returns, is a way to simplify people's lives, I think, and to avoid compliance issues because they do not get into that compliance system.

Senator CARPER. Thank you.

Mr. Bartlett, just very briefly.

Mr. BARTLETT. It has been a long time since I looked at the tax gap studies, but my recollection is that small businesses were a particular problem, more so than individuals, and perhaps this is simply an area where more resources need to be expended.

Senator CARPER. Good. Thank you.

Dr. DESAI. Just briefly, I think on the individual side, you would want to do what Mr. Fogg suggested, as Professor Bankman has suggested with ReadyReturns. I think that is a great idea. On the corporate side, I would adopt a simple true territorial system without a minimum tax and then fund it by looking at pass-through entities and the alignment of book and tax income.

Senator CARPER. All right. Thank you.

Ms. Markman?

Ms. MARKMAN. Yes. I think that the IRS should be granted the right to register and control tax preparers. I think that what happened with the *Loving* case is terrible. I think that it is very important, because that is where some of your problems clearly come from, and that would be my one recommendation.

Senator CARPER. Yes. I am Tom Carper, and I approve that message. [Laughter.]

Senator THUNE. Thank you, Senator Carper.

I want to try a couple of questions here, and then I will hand it off to Senator Heller.

Mr. Bartlett, you indicated that it has been a long time since anybody around here has done this. In fact, there are only a handful of people who were here last time. I was not here in this position as a Senator. I was here as a staffer in the 1985–1986 time frame, and there were some things that were strikingly different about that particular exercise than what we are seeing as we approach this issue today.

In your testimony, you stated that strong presidential leadership is going to be necessary to achieve any meaningful tax reform or simplification. So this is a fairly straightforward question, but how would you grade the current administration in terms of their leadership on this issue, their outreach to Capitol Hill, compared with your experience the last time around?

Mr. BARTLETT. Well, frankly, it has not been very good. It does not appear to me that either the Treasury Secretary or the President really have that much interest in the subject. Mr. Lew, as you know, was Budget Director. He is a budget guy, which is fundamentally different from being a tax guy, as I am sure you know. You look at the world in a slightly different sort of way.

I think it is too late in this administration to do anything meaningful in this area, but I do not think we need to reinvent the wheel either. One recommendation I would make is to go back to the Bush report in, I believe, 2005. It was actually pretty good, and I was very, very disappointed that President Bush chose not to pursue tax reform and instead did Social Security reform instead, so we ended up with neither. But I do not think it would take that much work to come up with an administration proposal if they put the massive tax staff at the Treasury to work on this.

Senator THUNE. Yes. And I do not disagree with that. I think that the level of engagement this time around, we just have not seen it at all relative to what happened in 1985 and 1986.

In your testimony, you stated that Congress should focus on "a few reforms that are not controversial if there is not the political consensus necessary for tax reform." So, to put that another way, maybe, in other words, we should not let the perfect become the enemy of the good. So what would you consider to be the non-controversial reforms that Congress could enact outside of a fundamental, comprehensive reform of the tax code?

Mr. BARTLETT. Oh, I think we have discussed quite a few things here today. The point I was trying to make is essentially the one you just made, which is, I think oftentimes we make the perfect the enemy of the good. I think that oftentimes there is a non-controversial tax provision that people would be willing to enact, but it is held hostage to say, well, we will use this as the vehicle, the engine to pull along some of the less popular, more difficult provisions. I just think that that has been going on for too long, and we have a backlog of things that could be done that should be done.

Senator THUNE. Let me just ask a couple of sort of specific questions on individual issues. One has to do with the individual and corporate Alternative Minimum Tax, and anybody who wants to can respond to this. But it was enacted really to prevent a small handful of taxpayers from avoiding taxes, yet today it ensnares literally millions of American taxpayers.

How much simplification would repeal of these taxes provide, and are the corporate and individual AMTs still necessary?

Ms. MARKMAN. The individual AMT is really a stealth tax. It requires many taxpayers to have to calculate the taxes twice. And the provisions, all of the add-backs that are there, the preferences that are in the law, really do not accomplish anything, as a tax preparer, from where I sit. It is just an unneeded complication.

If the rates were adjusted so the amount of money could be generated from the same group of taxpayers with different rates, I think we would greatly simplify the law. It is made more complicated now by this new net investment income tax that is added on top of the AMT, regardless of whether you pay the regular tax or you pay the AMT tax. So you have tax calculation upon tax calculation that has created a nightmare of complexity.

Senator THUNE. Does anybody else want to comment? Do we get rid of the AMT?

Mr. BARTLETT. I do not think you will find anybody who supports it in principle.

Senator THUNE. Final question. A lot of the preferences in the tax code phase out as a taxpayer's income rises so as to prevent these tax preferences from being claimed by higher-income taxpayers. The Child Tax Credit, of course, is one example of that.

How much complexity do these phase-outs add to the tax code, and is there a better way? If the concern is maintaining distributional neutrality, is there a better way of achieving that objective than having the phase-outs, which end up being pretty complicated, I think, for most people?

Ms. MARKMAN. If the exemption amount for children was changed, I think that would accomplish the goal about the Child Tax Credit, at least in part. Since right now we still face, with the Pease provisions, people losing their exemptions anyway, it is sort of a trade-off.

If we increase it, your low-income taxpayers would get the same or similar benefits to what they would get for the exemption amount, and the higher-income taxpayers would lose it as a result of those phase-outs. So you have to pick your poison, almost. It is a different way of looking at the same thing and has the same result.

Senator THUNE. All right.

Mr. FOGG. Do you not have phase-outs that come in at all different places depending on the particular item?

Ms. MARKMAN. Yes.

Mr. FOGG. And I think you could create simplification by figuring out who is a low-income taxpayer or who is a high-income taxpayer rather than have different provisions where the phase-out comes at different points. So, whether you want to keep the phase-outs is a different question, but right now it is sort of like education credits. You have so many different ones, it is difficult for people to keep up with.

Mr. BARTLETT. Well, one of the key areas of phase-outs is, as you know, with the EITC. If you look at phase-outs that apply to other welfare programs such as housing programs and things of that sort, some of the most highly taxed people in our society are very low-income people. I think that the only reason it does not impact them more is because they are simply not even aware of it. They find out after the fact.

Senator THUNE. All right.

Dr. DESAI. Just briefly, I think Pease is clearly a nightmare, as is the EITC story. I think what you would want to think about doing is aggregating some kind of a cap. That would be the way to simplify, as opposed to provision-by-provision exemptions.

Senator THUNE. Like a standard deduction?

Dr. DESAI. Well, but you could actually do it for higher-income folks as well. So, some kind of aggregation.

Senator THUNE. All right. Thank you.

The chairman has returned. Senator Heller is up next. Thank you all very much.

Senator HELLER. Mr. Chairman, thank you. I want to thank the witnesses for being here today and taking time. Your opinions are important to us, and your expertise is well noted. I want to go back to what Senator Thune was saying, and I hate to be duplicative, but I am going to be, Mr. Bartlett, in the question that he asked about presidential leadership.

As you are well-aware—and correct me if I am wrong, because I was quite young—but back in 1986, the last time we had tax reform, obviously President Reagan was involved. His chief of staff, Donald Regan, was involved. Treasury Secretary Baker was involved. Do you believe we can do fundamental tax reform without the presidential leadership? And tell me why it is so fundamentally important that the President and his administration be involved.

Mr. BARTLETT. Well, one reason is that we have two Houses of Congress and each one approaches things like tax reform separately. In other words, you do not always sit here and wait for the House to finish action before you begin action. You operate on parallel paths.

It is extremely important for some organization like the Treasury Department to keep an eye on everything that is going on on both sides of the Hill and make sure that the right hand and the left hand know what they are both doing, because it is so easy to make mistakes and create penalties that were not intended or subsidies that were not intended. And of course, when you are in the hothouse atmosphere of a conference committee, a lot of decisions get made in the blink of an eye.

It is just really important to have somebody or some institution with the resources to keep an eye on all the different things, all the different moving parts that are moving simultaneously, to make sure that you end up at the end of the day with something that improves the tax system.

Senator HELLER. Right. So I guess I ask the question, can we do it without the administration?

Mr. BARTLETT. Personally, I do not think so. I am not aware of any major tax reform in history that did not originate with or have deep administration involvement. The 1969 Act was essentially drafted by the Treasury Department.

I am not sure precisely who drafted the 1976 Act, but of course the 1986 Act came out of a massive Treasury study. Although a lot of it was abandoned, a lot of it stayed, and so I just think the history shows that, if you are talking about tax reform as opposed to a tax cut, it is just absolutely essential.

Senator HELLER. Great. Mr. Bartlett, thank you.

Dr. Desai, in one of your comments, you mentioned that lawmakers could get revenue through pass-through entities. As we are looking at overhaul of the tax code, could you explain how we might be able to do that?

Dr. DESAI. Well, just so we understand the magnitude of the numbers, if you think about how much business income is being taxed through the corporate tax, about two-thirds of it is not being taxed through the corporate tax. So now more than ever before, we have business income in non-corporate form, and that is pass-through entities. It is also real estate investment trusts, it is MLPs. There is a proliferation of entities out there.

What is basically happening is corporations have figured out that there is a ready way to take a bunch of income. They hive themselves into what are called prop cos and op cos—property companies and operating companies—and they put all that property income into a pass-through entity. That is highly problematic. So to address it, one would want to think about having some kind of a minimum tax on income that is generated through pass-through entities, and even a small tax there would actually raise a remarkable amount of revenue.

I will just mention there, the revenue raiser is that we have a situation where corporations routinely report large profits to capital markets and do not report those same profits to tax authorities, and that is a conundrum. It could be fixed if there was a better alignment on defining income for tax authorities and capital markets.

Senator HELLER. Dr. Desai, thank you.

This is probably a question, if time allows, for us to go down the row. We have had a number of proposals come before us. Some examples, of course, are the Simpson-Bowles Commission; the previous Senate Finance Committee chairman, Max Baucus, had some ideas on how to address the complexity in the tax code; and of course, our prior Ways and Means Committee chairman, Dave Camp.

So we have had numerous ideas that have come in front of this Congress. I think this is as bipartisan an issue as possible, and that is the simplification of our tax code. I think we can get agreement on both sides of the aisle.

What are your views on these various proposals?

Ms. MARKMAN. I am really not sufficiently versed to be able to address them one at a time. But I think that if they were studied and they were looked at, and we said, okay, we are going to pick the best ideas or the best three ideas from each of them, you probably would come up with something very good, because each of them is well thought-out, and they were comprehensive. But specifically, I am sorry, I cannot address that.

Senator HELLER. Thank you.

Doctor?

Dr. DESAI. I would just briefly say that the best compendium of good ideas that we have in the recent past is the President's Advisory Panel on Federal Tax Reform that was done in 2005. That was——

Senator HELLER. The Simpson-Bowles?

Dr. DESAI. No, this was a committee that was put together and was roughly abandoned, but that 2005 report is a great place to look.

Senator HELLER. Thank you.

Mr. BARTLETT. If memory serves, the Joint Committee was required to produce a three-volume study on complexity and simplification not that many years ago. I do not think the law has changed that much since then. Perhaps the Joint Committee could boil some of that down into something that could be legislated.

Senator HELLER. Mr. Fogg?

Mr. FOGG. I am going to just address it from the perspective of low-income taxpayers. So the more you get them out of the system, the happier they will be. When you use the tax system to deliver benefits, you are dragging them back in, and that is creating problems for them. So that is a form of benefit-giving that is creating a lot of complexity for their lives.

Senator HELLER. Thank you very much. Mr. Chairman, thank you, and thanks for your commitment to this issue.

The CHAIRMAN. Well, thank you, Senator Heller.

Let me just ask one other question of you, Dr. Desai. You commented in your testimony about the "planning complexity" dynamic in the international tax arena. First, would you provide us some context around this dynamic? Second, would you agree that moving our international tax rules in the direction of the President's proposal, the 19-percent minimum tax, would do more harm by enhancing rather than alleviating the planning complexity dynamic, and that a move to a territorial-type system of tax administration is a better path forward?

Dr. DESAI. Well, so the dynamic I was alluding to, I think, is most evident in the international arena, but I think it is broad, and that is a dynamic where there is a concern about planning and there are rules and laws passed to address it. That creates complexity which planners can then plan around. That creates another effort to address it, and so on and so forth, and the international system is rife with that. There are various examples of it.

Right now I think the minimum tax is such an example, which is, it is an effort within what is broadly a territorial system to basically repeal deferral. The consequence of that is going to be a remarkable amount of effort to engineer around those rules by people who have enormous resources. So my instinct is that it is going to, (A) cause more harm than good, and (B), if you have that policy goal, which I disagree with, you would be better to repeal deferral. That would be a simple way to achieve that.

One of the things that is important here is to achieve things in the simplest way. Things like Pease that are stealth taxes, or things like a minimum tax in a territorial system that is a self-tax, or the AMT, they are highly problematic, and this is just one example of them. So, yes, I think obviously the right way to go is a much simpler system, which would be a true territorial system.

The CHAIRMAN. Well, thank you. This has been a particularly interesting panel to me. I am sorry I had to go to the anti-trust hearing over at Judiciary. I apologize that I missed part of your testimony. But what I heard was very, very helpful to this committee. I just want to thank each of you for appearing today and taking the time to be with us.

We are going to see what we can do to simplify this tax system that we have. It is going to take an awful lot of effort and an awful lot of help from not just people here, but people outside as well. We

hope you will help us, and continue to help us understand how to do this and what we should do a little bit better than maybe has been the case in the past.

So I want to thank each of you for taking the time out of your busy schedules to be with us, and, with that, we will recess until further notice.

[Whereupon, at 11:48 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF BRUCE BARTLETT, FORMER DEPUTY ASSISTANT SECRETARY FOR ECONOMIC POLICY (1988–1993), DEPARTMENT OF THE TREASURY

Thank you for the opportunity to testify today on the subject of tax complexity, compliance, administration and simplification. I speak not as a tax practitioner, but as someone who has observed the tax policy process at close hand for several decades and written frequently on the subject. I will confine my comments to general observations about what has given rise to tax complexity, what "simplification" means in practice, and obstacles to the achievement of meaningful simplification.

1. ***Distribution tables drive a lot of complexity.*** Although it is seldom said out loud, an important underlying assumption in all major tax bills is rough distributional neutrality or mild progressivity. This means that tax writers are vitally dependent on the distribution tables produced by the Joint Committee on Taxation. There are many technical and conceptual problems with these tables that I won't go into.[1] One longstanding problem is that no one is quite sure who exactly pays the corporate income tax.[2] I will simply note that if a table looks "wrong" by giving too much of a tax cut to those at the top, this requires redress through some mechanism to take back part of the cut to those in some specific income group as the JCT defines "income."[3] Often these fixes are complicated and convoluted; I'm thinking about PEP and Pease, for example.[4]

2. ***It's very hard to cut income taxes without disproportionately benefitting the rich.*** That is because they pay most of the taxes. Any simple cut in rates, even if it is across the board, will produce distribution tables showing massive tax cuts for those at the top, very modest cuts for those in the middle, and nothing at all for those at the bottom because they have no income tax liability. The only way you can "cut taxes" for those with no liability is by making a tax credit refundable. But this simply redefines direct spending into a tax benefit, which is somewhat Orwellian, but satisfies the need to get a distribution table that looks "right."

3. ***Just because some person or business has no income tax liability doesn't mean they are relieved of tax complexity.*** When the Tax Reform Act of 1986 was enacted, President Reagan praised it for tax simplification based largely on the fact that a number of taxpayers had been taken off the tax rolls.[5] In effect, he was asserting that paying no income taxes was per se simplification. Of course, this was nonsense. The EITC is the primary reason many people with positive income have no tax liability and often receive a "refund" even though they paid no taxes to be refunded. But the EITC involves complex calculations. Similarly, many small busi-

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[1] Michael J. Graetz, "Paint-By-Numbers Tax Lawmaking," *Columbia Law Review* (April 1995).

[2] Some recent contributions to the debate on this topic include, "Modeling the Distribution of Taxes on Business Income," *Joint Committee on Taxation* (Oct. 16, 2013); Julie-Ann Cronin et al., "Distributing the Corporate Income Tax: Revised U.S. Treasury Methodology," *National Tax Journal* (March 2013); "How TPC Distributes the Corporate Income Tax," *Tax Policy Center* (Sept. 13, 2012); Kimberly A. Clausing, "Who Pays the Corporate Tax in a Global Economy?" *National Tax Journal* (March 2013).

[3] Edward D. Kleinbard, "Reading JCT Staff Distribution Tables: An Introduction to Methodologies and Issues," *Joint Committee on Taxation* (Dec. 9, 2008).

[4] "Deficit Reduction: The Economic and Tax Revenue Effects of the Personal Exemption Phaseout (PEP) and the Limitation on Itemized Deductions (Pease)," *Congressional Research Service* (Feb. 1, 2013).

[5] Ronald Reagan, "Remarks on Signing the Tax Reform Act of 1986," *The White House* (Oct. 22, 1986).

nesses with little or no tax liability may still have complicated returns. And there are big corporations that often have no tax liability that work very hard and jump through a lot of complicated tax hoops to achieve that result. My point is simply that just because someone has no tax liability doesn't mean they automatically have simple taxes, and just because some legislation increases the number of non-taxpayers doesn't mean that Congress has made the Tax Code simpler.

4. ***Some of the most serious issues in tax complexity are fundamental to the very nature of an income tax.*** The problem is that it is becoming harder and harder to say precisely what "income" is, or at least taxable income, in today's world. As this committee knows, the term "income" is nowhere defined in law.[6] Once upon a time when the only income most people received was wages, pensions and perhaps a bit of interest, this was not a problem. But more and more workers these days, such as Uber drivers, are independent contractors; in effect, small businesses, with expenses and incomes that may take multiple forms. The wealthy, especially if they are business owners, can often easily convert wage or interest income into lower-taxed capital gains or dividends. And of course big corporations have whole departments devoted to avoiding the realization of taxable income. Most of the Tax Code's complexity comes from reporting income.[7]

5. ***Adopting a consumption tax has the potential to achieve meaningful simplification.*** One reason is that consumption is more easily defined and taxed, especially in an increasingly globalized economy, than income.[8] Thus we would be shifting the tax base from something that is increasing intangible to something that is more concrete.[9] Another benefit is that the burden of tax collection would be shifted from individuals to businesses that are better able to employ tax experts. Of course, even consumption taxes break down and Europe has a growing problem with VAT evasion.[10] But at least in principle, individuals would benefit in terms of simplification by paying their taxes as they buy things, rather than having to keep track of income and all the exemptions, exclusions, deductions and credits that go with our income tax system.[11] I am highly sympathetic to the tax plan devised by Columbia University law professor Michael Graetz, which would go a long way toward achieving meaningful simplification for most people by eliminating their need to keep records or even file returns.[12]

6. ***We could do a lot more to achieve no-return filing for many people even within the current tax system.*** Few people realize that even under current law, the IRS will calculate your taxes for you if you have a limited income sources, don't itemize or use special tax forms, and have an income below $100,000.[13] Any number of studies by the Treasury Department and others have shown how return-free filing could be expanded.[14] Other countries have such a system.[15] One problem is that return-free filing would probably require increased withholding on things like divi-

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[6] Alice C. Abreu and Richard K. Greenstein, "Defining Income," *Florida Tax Review* (2011); Erik M. Jensen, "The Taxing Power, the Sixteenth Amendment, and the Meaning of 'Incomes,'" *Arizona State Law Journal* (Winter 2001); Martin D. Ginsburg, "Taxing the Components of Income: A U.S. Perspective," *Georgetown Law Journal* (Oct. 1997).

[7] Rosemary Marcuss et al., "Income Taxes and Compliance Costs: How Are They Related?" *National Tax Journal* (Dec. 2013).

[8] James R. Hines Jr. and Lawrence H. Summers, "How Globalization Affects Tax Design," *Tax Policy and the Economy* (July 2009).

[9] Edward J. McCaffery, "A New Understanding of Tax," *Michigan Law Review* (March 2005).

[10] "2012 Update Report to the Study to Quantify and Analyse the VAT Gap in the EU–27 Member States," *European Commission* (Sept. 2014); Michael Keen and Stephen Smith, "VAT Fraud and Evasion: What Do We Know and What Can Be Done?" *National Tax Journal* (Dec. 2006).

[11] Bruce Bartlett, "The Conservative Case for a VAT," *Tax Analysts* (Feb. 11, 2011).

[12] Michael Graetz, "The Tax Reform Road Not Taken—Yet," *National Tax Journal* (June 2014).

[13] IRS, *Tax Guide for Individuals, 2014,* p. 205.

[14] U.S. Treasury Department, *Report to the Congress on Return-Free Tax Systems: Tax Simplification Is a Prerequisite* (Dec. 2003); Austan Goolsbee, "The Simple Return: Reducing America's Tax Burden Through Return-Free Filing," *Brookings Institution* (July 2006).

[15] William G. Gale and Janet Holtzblatt, "On the Possibility of a No-Return Tax System," *National Tax Journal* (Sept. 1997); Koenraad Van der Heeden, "The Pay-As-You-Earn Tax on Wages: Options for Developing Countries and Countries in Transition," *International Monetary Fund* (Sept. 1994). Just the other day, I noticed that Singapore's Inland Revenue Authority was praising the benefits of its no-filing service.

dends and interest. I don't need to remind this committee how unpopular that would be.[16]

7. ***Contrary to popular belief, a single statutory rate tax does very little to simplify the tax system.*** In 1978, there were 26 statutory income tax brackets; 10 years later there were only two. It was widely believed that this led to meaningful simplification for individuals. In fact, the simplification was superficial; the vast bulk of complication in the tax system comes from defining the tax base. The great advance in simplification promised by the original flat tax proposal developed by Stanford scholars Robert Hall and Alvin Rabushka came from adopting a pure consumption tax base; the single rate was basically the cherry on top.[17] In any case, it is effective marginal rates that matter, economically, and just about any effective rate can be achieved even under a flat rate system depending on the nature of the tax base. Furthermore, surveys have shown that hardly anyone knows what their tax bracket is and tend to grossly overestimate it. Keep in mind also that the corporate tax has always been essentially a flat rate, but no one thinks the corporate tax system is simple. There is no evidence that fewer tax brackets improves economic efficiency.[18]

Table 1—Tax Rate Perceptions and Reality, 2010

On average, about what percentage of their household incomes would you guess most Americans pay in federal income taxes each year—less than 10 percent, between 10 and 20 percent, between 20 and 30 percent, between 30 and 40 percent, between 40 percent and 50 percent, or more than 50 percent, or don't you know enough to say?

Tax/Income	All	Tea Party Members	Actual
Less than 10%	5%	11%	86.5%
10%–20%	26%	25%	12.9%
20%–30%	25%	26%	0.6%
30%–40%	10%	14%	0.6%
40%–50%	2%	3%	0.6%
More than 50%	1%	1%	0.6%
Don't know	31%	15%	n/a

Sources: *New York Times/CBS News Poll, Joint Committee on Taxation.*

8. ***Even radical simplification and reform is highly unlikely to raise economic growth more than a small amount and only over a long period of time.***[19] I know that there are estimates of the compliance cost and the deadweight cost of the tax system that are very high.[20] But the compliance cost is like the cost of commuting to and from work; reducing it would improve our well-being, but wouldn't necessarily raise growth and might even reduce it based on the way GDP is calculated. Reducing the deadweight cost would have an effect similar to reducing the effective marginal tax rate. But as we know from experience after the 1986 reform, which lowered the top rate from 50 percent to 28 percent, there was no outpouring of growth. Serious efforts by economists to find any economic impact from the 1986 Act have turned up very little; mostly accounting changes, not real eco-

[16] Withholding on interest was instituted by the TEFRA legislation in 1982. It was so unpopular it was repealed six months after taking effect. "Congress Passes Repeal of Interest Withholding," *New York Times* (July 29, 1983).

[17] Charles E. McLure Jr., "The Simplicity of the Flat Tax: Is It Unique?" *American Journal of Tax Policy* (Fall 1997); Lawrence Zelenak, "The Selling of the Flat Tax: The Dubious Link Between Rate and Base," *Chapman Law Review* (Spring 1999); Alan L. Feld, "Living With the Flat Tax," *National Tax Journal* (Dec. 1995).

[18] David Altig and Charles T. Carlstrom, "The Efficiency and Welfare Effects of Tax Reform: Are Fewer Tax Brackets Better Than More?" *Federal Reserve Bank of Cleveland* (1994).

[19] Nancy L. Stokey and Sergio Rebelo, "Growth Effects of Flat-Rate Taxes," *Journal of Political Economy* (June 1995); William G. Gale and Andrew A. Samwick, "Effects of Income Tax Changes on Economic Growth," *Brookings Institution* (Sept 9, 2014); "Economic Growth and Tax Policy," *Joint Committee on Taxation* (Feb. 20, 2015).

[20] Martin Feldstein, "Tax Avoidance and the Deadweight Loss of the Income Tax," *Review of Economics and Statistics* (Nov. 1999); "Summary Estimates of the Costs of the Federal Tax System," *U.S. Government Accountability Office* (Sept. 27, 2005).

nomic effects.[21] The effect of statutory tax rates on growth tend to be grossly exaggerated.[22]

9. ***Strong presidential leadership will be necessary to achieve any meaningful tax reform or simplification.*** Political studies of the 1986 act show that President Reagan's personal commitment and the active engagement of the Treasury Department were essential to its enactment.[23] One problem, as this committee well knows, is that of what is sometimes called "salami-slicing," small compromises to a proposal that was carefully balanced can eventually add up to something worse than nothing at all. I am disappointed that President Bush chose to ignore the recommendations of his tax reform panel, which were very good, and that President Obama and the Treasury have shied away from active engagement in this issue other than to offer a relatively limited business-only reform proposal.[24] The expiration of the Bush tax cuts would have been a perfect opportunity to develop a larger tax package that would have improved the tax code, but it was not utilized.

10. ***Tax policy should pay more attention to horizontal equity.*** It is a generally accepted principle of taxation that those with similar incomes should pay similar taxes. The complexity of our current system, however, causes tax rates to vary tremendously between those with roughly the same income. The following table and figure illustrate this point.

Table 2—Distribution of Average Federal Tax Rates, 2012

Family cash income group	Average rate at each breakpoint in the rate distribution				
	10th	25th	Median	75th	90th
Lowest quintile	−13.7	0.0	5.4	13.1	15.5
Second quintile	−8.7	0.5	7.2	17.0	20.9
Middle quintile	1.7	5.4	13.3	20.4	23.5
Fourth quintile	7.2	12.1	17.2	22.3	26.2
Highest quintile	12.1	17.4	21.9	26.0	29.3
Top 1 percent	8.7	21.2	29.6	32.3	34.6
Total	0.0	5.0	14.5	20.7	25.0

Source: Treasury Department; includes income, corporate and payroll taxes.[25]

[21] Alan J. Auerbach and Joel Slemrod, "The Economic Effects of the Tax Reform Act of 1986," *Journal of Economic Literature* (June 1997); David A. Guenther, "Earnings Management in Response to Corporate Tax Rate Changes: Evidence from the 1986 Tax Reform Act," *Accounting Review* (Jan. 1994); Anil Kumar, "Labor Supply, Deadweight Loss and Tax Reform Act of 1986: A Nonparametric Evaluation Using Panel Data," *Journal of Public Economics* (Feb. 2008).

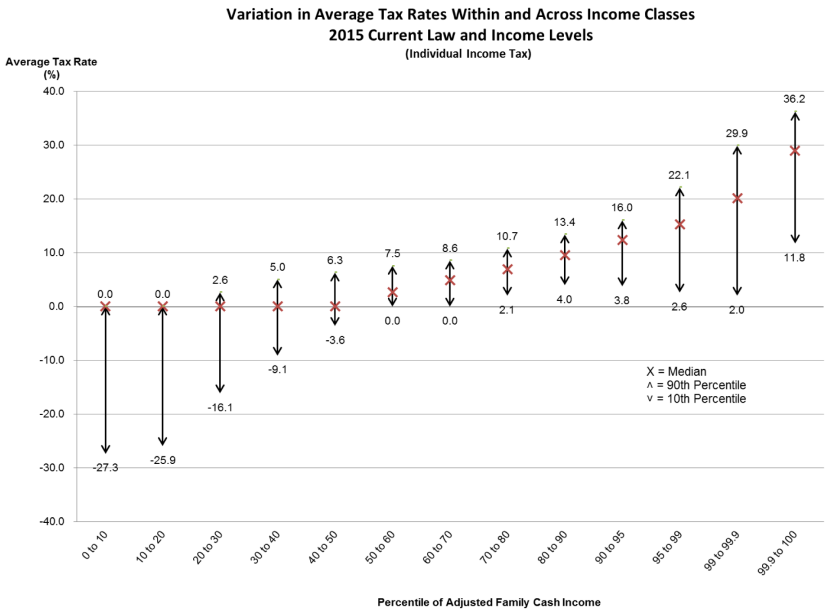
[22] "Tax Rates and Economic Growth," *Congressional Research Service* (Jan. 2, 2014); "Taxes and the Economy: An Economic Analysis of the Top Rates Since 1945," *Congressional Research Service* (Dec. 12, 2012).

[23] Robert P. Inman, "Presidential Leadership and the Reform of Fiscal Policy: Learning from Reagan's Role in TRA 86," *NBER Working Paper No. 4395* (July 1993); John F. Witte, "The Tax Reform Act of 1986: A New Era in Tax Politics?" *American Politics Research* (Oct. 1991).

[24] President's Advisory Panel on Federal Tax Reform, *Report* (April 13, 2005); "The Advisory Panel's Tax Reform Proposals," *Congressional Research Service* (July 13, 2006); "The President's Framework for Business Tax Reform," *White House and Treasury Department* (Feb. 2012).

[25] Council of Economic Advisers, *Economic Report of the President, 2012,* p. 88.

Figure 1



Source: U.S. Treasury Department, Office of Tax Analysis (Sept. 23, 2014).

11. ***Please make all the "extenders" permanent or get rid of them.*** This is particularly a problem with the R&D credit, which has been extended 16 times, often retroactively.[26] By never having been enacted permanently, it fails to achieve its purpose of stimulating additional R&D and is instead a reward for what companies would have done anyway.[27]

12. ***Combine overlapping tax incentives for the same purpose.*** There are many tax subsidies for education, retirement saving and other worthwhile purposes.[28] Consolidating these incentives would not only achieve simplification, but provide an opportunity to better target them toward those that need them.

13. ***Please give the IRS more money.*** It has been forced to cut back on taxpayer assistance because of cuts to its budget.[29] It has also cut back on audits, thus making the tax system more unfair by rewarding tax evaders.

14. ***Give up on fundamental tax reform for now and concentrate on a few reforms that are not controversial and will help improve and simplify the Tax Code.*** The dream of a tear-up-the-tax-code-and-start-over-from-scratch reform is very appealing, but it has never been done in our history. Even a reform as big as those in 1969, 1976 and 1986 appears beyond reach in the present political environment. The hope of doing a big once-and-for-all reform, unfortunately, has held hostage legislation that is needed and would incrementally improve the code. I think some members of Congress believe that noncontroversial reforms need to be saved for fundamental tax reform, perhaps as sweeteners. An alternative view would be that if Congress can just do any kind of meaningful reform on a bipartisan basis,

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[26] Michael Brossmer et al., "Sweet 16: The Research Tax Credit Gets Its 16th Extension," *Tax Notes* (March 2, 2015).

[27] McGee Grigsby and John Westmoreland, "The Research Tax Credit: A Temporary and Incremental Dinosaur," *Tax Notes* (Dec. 17, 2001).

[28] Elaine Maag, "Tax Simplification: Clarifying Work, Child, and Education Incentives," *Tax Notes* (March 28, 2011).

[29] Liz Weston, "Prepare to Wait for U.S. Tax Help," *Reuters* (March 2, 2013); "Observations on IRS's Operations, Planning, and Resources," *U.S. Government Accountability Office* (Feb. 27, 2015).

which is essential, then maybe it would improve the prospects for everyone working together on something bigger.

15. ***It does nothing to restrain the growth of taxation to make paying our taxes as difficult as possible.*** There is a school of thought that says the more painful taxes are the more people will hate them, which will encourage support for tax cuts and opposition to tax increases.[30] This has always been the principal reason why many conservatives oppose the VAT—they fear that is too good a tax and thus will lead to a higher tax burden than would be the case if tax collection and payment is extremely burdensome. But it should be remembered that the deadweight cost of taxation—the lost production over and above the tax—is an implicit tax. So by maintaining and excessively burdensome tax system to keep the explicit tax take as low as possible, we are simply imposing higher de facto tax rates in another form.

PREPARED STATEMENT OF MIHIR A. DESAI, PH.D., MIZUHO FINANCIAL GROUP PROFESSOR OF FINANCE AND PROFESSOR OF LAW, HARVARD UNIVERSITY

Chairman Hatch, Ranking Member Wyden, and Members of the Committee, it is a pleasure to appear before you today to discuss tax complexity and the importance of simplification. I am a Professor of Finance at Harvard Business School, a Professor of Law at Harvard Law School and a Research Associate of the National Bureau of Economic Research.

Complexity in the tax code has negative redistributive and growth consequences that have only accelerated over time as more and more policy goals are now implemented through the tax system. My comments attempt to outline briefly the harmful effects of complexity, particularly egregious examples of complexity, and a proposal for remedying complexity in the tax code.

1. Our complex economy must be matched with thoughtful and detailed tax rules. As such, railing against all complexity is naive. Instead, the types of complexity that deserve our attention are either (i) when taxpayers have difficulty in complying with the law, (ii) when the IRS cannot enforce the laws, or (iii) when complexity gives rise to planning opportunities.

   Compliance complexity is most prevalent with individual taxpayers and small businesses. The web of education incentives in the tax code provides a paradigmatic example of such complexity. Compliance complexity retards efforts of policymakers by reducing uptake, increases the likelihood that the behavior rewarded with tax expenditures is inframarginal (leading to windfalls to taxpayers rather than to the desired changes in behavior), and redistributes wealth toward sophisticated taxpayers and tax advisers who can manage this complexity.

   Administrative complexity is most common with business taxes and is manifest, for example, when the IRS relies on the actions of auditors, as independent verification is often beyond the abilities or resources of the IRS. This type of complexity again rewards sophisticated taxpayers and investment in non-productive activity but also creates a crisis of confidence in the tax code when taxes effectively become optional for sophisticated taxpayers. [See Reference 4]

2. The final type of complexity arises from a "call and response" pattern of tax planning by practitioners that provokes more detailed, bright-line rules by administrators that, in turn, triggers new tax planning opportunities and so on. This death spiral of planning-regulation complexity is evidenced in the most important area of business taxes—international tax rules—where complex rules govern an unwieldy system that raises little revenue. As a recent example of this dynamic, last year's Treasury notice designed to prevent inversion transactions will have the primary effect of transferring wealth to foreign multinational firms and those firms that inverted prior to the proposed regulations as they have become advantaged acquirers of U.S. assets. Indeed, several years of anti-inversion legislation and rules have only served to increase the planning activities around mergers and the real distortions undertaken to achieve tax savings.

3. Recent proposals to enact an alternative minimum tax on foreign source income within a proposed territorial regime provide the latest example of the vices of this planning-complexity dynamic. Such proposals attempt to prevent planning by implementing a *de facto* worldwide system of taxation without deferral at, for

[30] Gary S. Becker and Casey B. Mulligan, "Deadweight Costs and the Size of Government," *Journal of Law and Economics* (Oct. 2003).

example a nineteen percent rate, on a per country basis but label it a territorial regime. It would be preferred to explicitly repeal deferral within a worldwide regime rather than to enact such a "backdoor" worldwide regime—much as today's worldwide system that functions as territorial is much worse than a true territorial regime. Such complexity creates numerous opportunities for planners that have resources that far eclipse the ability of the government to police them—and their efforts will trigger a new round of regulations with further distortions and more planning opportunities. A simple territorial system as implemented by governments around the world, with anti-abuse provisions and a simple adjustment to address expense allocation, provides the best alternative to ensure that the corporate tax systems advances, rather than retards, the interests of American workers and firms. [See References 5, 6 and 7]

4. Addressing complexity in the tax code requires analogizing to other complex systems and drawing on the research that demonstrates how to manage that complexity. In short, the complexity of the tax code could be managed much as the complexity of software code is managed. This analogy yields two primary lessons. First, "over the wall" engineering is highly problematic and "concurrent" engineering is preferred. Throwing completed ideas "over the wall" to the next part of the production process limits learning and engenders complexity relative to a concurrent and iterative production process. Currently, policy ideas are often developed without a clear vision of the associated language and with even less attention to the perspective of administrators. The practice of policy formulation and drafting must be a collaborative activity with the administrative agency in charge of enforcement. More consistently following and strengthening the recommendations in Sections 4021 and 4022 of The Internal Revenue Service Restructuring and Reform Act of 1998 would provide for a considerable bulwark against creeping complexity by preventing "over the wall" engineering.

5. Second, and more radically, we could embark on an effort to open up the administrative and legislative process in order to effectively "crowdsource the code." Effective management of complex codes—be it Linux or the tax code—requires three steps. First, a code must be mapped so that the interrelationships, technically and conceptually, of the different parts of the code become manifest. Second, this mapping enables modularization whereby the code is reorganized into pieces that reflect these relationships. Finally, this modularization provides the foundation for opening up the code to experts throughout society who contribute suggestions for rationalization and simplification. [See References 2, 8, 9, 10, and 11]

6. Currently, the code, to the degree its complexity is managed at all, is managed much as it was fifty years ago—in a fundamentally closed manner. Laws and administrative guidance are drafted by small groups in a non-transparent way that pays little attention to the overall architecture of the tax system. As a consequence, vested interests influence the management of complexity toward their advantage and complexity grows by ignoring interrelationships.

7. By mapping, modularizing and opening the code and associated guidance we could draw upon widespread expertise, provide transparency on a critical process, address the imbalance in resources between the taxing authority and sophisticated taxpayers and begin the process of simplifying the code and the associated administrative guidance. A modest manifestation of the power of crowdsourcing ideas on the code is provided in Appendix A, which compiles the suggestions of twenty experts on complexity. In the limit, one could imagine a detailed mapping of the tax code and associated regulations much as software code is mapped. This mapping would then serve as a guide to reorganizing laws and regulations over time. While decision making rights would remain where they currently reside, opinions on policies would then be solicited widely and the drafting of laws and regulations could be aided by experts around the country through an open platform.

8. Finally, three structural features of our tax system most contribute to complexity. First, consumption taxes have major simplification advantages over income taxes as the base is more readily identified, particularly given the growing importance of cross-border flows and intellectual property. Second, the reliance on realization events engenders great complexity that could be alleviated by considering accrual taxation in some settings. Third, the reluctance to embrace solutions that provide taxpayers with the information that tax authorities already have, as with ReadyReturns, is a major cause of unnecessary complexity in the

individual arena. Structural reforms that address these sources of complexity would allow for considerable simplification. [See References 1, 3, 4 and 12]

I look forward to your efforts in this important area and I'd be delighted to answer any questions.

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Appendix A
Identifying Excessive Complexity in the Code

This appendix provides an anonymized catalog of responses from twenty-one tax experts when asked about areas of excessive complexity

#1

An obvious candidate for excessive complexity are the "anti-NOL-trafficking" rules of section 382 and the regulations thereunder, especially the aspects of the rules that require a corporation to identify and track 5+% shareholders or "public groups" of shareholders to determine whether there has been an "ownership change" with respect to the corporation, in which case its ability to use its pre-existing NOLs and other tax attributes to shelter future taxable income is limited. The IRS has in the last few years issued some regulations that ease the burden of applying these rules, but they are still inordinately complex in their application.

#2

Section Code 704(b):

(b) A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

In English, this means that allocations of income are dictated by the partnership agreement. If, however, the such an allocation does not have "substantial economic

effect," then the correct allocation for tax purposes will be determined by the "partner's interest in the partnership" (i.e., the real economics of the deal.)

The real complexity is in the 704(b) regs. Take a look. They are astounding. The regs provide various safe harbors. So complex, in fact, that they are mostly disregarded in private equity funds, as many funds opt not to try to comply with the rules, and instead rely on the baseline rule in the statute that if an allocation does NOT have substantial economic effect, then the correct allocation will be determined by the "partner's interest in the partnership."

There are a couple of simplification options. One option is to abolish non-economic or "special" allocations.

Another is to eliminate subchapter K and instead tax all partnerships through the subchapter S rules (with some minor modifications). I think Dave Camp proposed this as an option. Perhaps the easiest, politically, is simply to revise 704(b) to make the baseline rule of "partner's interest in the partnership," i.e., tax follows economics. There will obviously be some cases where it is unclear whether a tax allocation does in fact follow economics. But most partnerships are concerned with business goals, not tax avoidance, and it's not like current law makes it easy to police tax avoidance. So let's make it easy for the vast majority of partnerships that just want to accomplish business goals.

#3

A. Examples that affect reasonably ordinary events or a large number of people—the capital gain rules for individuals' business property and the earned income tax credit.

1. I buy a computer in 2014 and sell it in 2015. For basis I go to 1011, 1012, 1016 (subtracting applicable 179 expensing (if elected) and 167/168 depreciation). Amount realized should be simple assuming I do not take back a note. I go to 1223 for my holding period. If the computer is used (in whole or in part) in my business, 1245 depreciation recapture will apply, and gain in excess of depreciation goes through 1221(2) to the 1231 hotchpot. If some gain is capital, it goes through 1222 waterfall. I have to apply 1(h) rate rules. It is worse if it is real property used in my business because of 1250 and 1(h). This could be a lot simpler without having to shift to a consumption tax (where other problems arise).

Quick fixes (without much thought): As in 1986, repeal preferential capital gain rate (especially if overall rates go close to 30%) and allow all capital losses (short- and long-term) to net; repeal 1231 under any circumstance; if preferential capital gain is retained make it a percentage deduction.

Counter argument: This is mostly calculation complexity and can be done on TurboTax, which most business people can use.

2. EITC: I would just send you to the pages in the 1040 instructions for the EITC to prove this point. Nina Olson's National Taxpayer Ombudsman Report of a few years ago highlighted EITC among a series of complexity issues and it is annually on the list of highest erroneous government payments.

Quick fix: Make the credit/refund a percentage of payroll/self-employment tax paid keyed to filing status and family size—Nina's report may have had a better idea.

Counter argument: There really is not a good one if we insist on using the tax system to transfer payments.

Taxing a child's investment income at parent rates is incredibly complex but affects fewer people and rich kids (or kids of rich parents) tend to be less sympathetic.

B. My second response is that every formal taxpayer election (not to mention de facto elections) increases complexity because it calls for running the numbers both ways (not that everyone does). I question the need for 95%–99% of the formal elections in the Code. If it is necessary to use an election, the rule is a bad one or a political itch is being scratched. But each one must be coded, monitored by the IRS and thought about by taxpayers and advisers. There are hundreds.

Two of many possible sources for ideas are: New York State Bar Association Tax Section Report 1007, Simplification of the Internal Revenue Code (March 18, 2002) and JOINT COMM. ON TAX'N, RECOMMENDATIONS FOR SIMPLIFICATION,

Vol. I (sources of tax complexity generally), Vol. II (April 2001) (specific categories of issues).

I worry less about complexity for very sophisticated and rich taxpayers (most MNEs, PE funds and portfolio companies and high net worth individuals and trusts). I also would not give them elections.

#4

Get rid of the individual and corporate alternative minimum tax. Why should you have to calculate your tax, and then calculate it again another way. If Congress does not like certain preferences, then they should be eliminated.

For a while I filled out my father's tax returns. He lived in NJ, a high-tax state. One spring I filled out his Form 1040 and calculated his regular tax. Then I told him we had to fill out another form (6251) to calculate whether he owed AMT. He was outraged. He said: "I am 80 years old. I do not pay this alternative minimum tax." I said: "There is no exception for octogenarians." He said, "You're fired!" I said, "You can't fire me. First of all, you aren't paying me anything to do this. Secondly, I am your son—you can't fire your son." He said: "You wanna bet? You're fired." In the end he owed AMT.

#5

Another question is the type of complexity. Education incentives, e.g., are easy to comply with—just plug everything into TurboTax and see what comes out—but present complex incentives since no one really knows how they're affected at the time of the expenditure. OTOH, tracking deductible business expenses is complicated and time-intensive, but the rule is easy to understand. Then, of course, there are those provisions that just don't make sense and you need armies of lawyers to interpret.

I think the original sin of most of the worst complexity in the Code is the realization requirement—again, easy to understand, but creates enormous problems.

#6

I find the IRA rules to be unconscionably complex, particularly in that the complexity falls on individual taxpayers. I would cite the contribution limits, especially for retirement-plan participants (section 219), eligibility for Roth contributions (section 408A), the excise tax for getting the contribution limits wrong (section 4973), the age 70-1/2 distribution requirements (sections 408(a)(6) and 401(a)(9)), the other distribution rules (section 408(d)), and the numerous exceptions to the 10-percent early withdrawal penalty tax (section 72(t)).

#7

Some of the most complex areas of the U.S. tax rules pertain to the taxation of foreign income. The following is a summary of some of these complex rules. We can provide additional detail, if useful.

Foreign tax credits: There are highly detailed and complex rules relating to foreign tax credits e.g., IRC 901–909.

- Certain of the rules are designed to limit credits only to foreign levies that are a tax on net income.
- Other rules are designed to prevent the cross-crediting of high taxes on one stream of income against another stream of low-taxed foreign-source income.
- Income and associated taxes are split into separate groups—so called "baskets" (i.e., taxes in one basket cannot be credited against income in another basket). Generally, income/taxes are separated into a "passive" basket (which includes dividends, interest, royalties, rents and similar income not derived in connection with an active business) and a "general" basket (other income), with high-taxed passive income (i.e., income subject to foreign tax in excess of the U.S. rate) being excluded from the passive basket.
- Intercompany dividends, interest, royalties and rents are characterized on a "look-through" basis by reference to the underlying earnings from which the amount is paid.
- There are complex rules (the so-called "splitter rules")—designed to address circumstances where the entity treated as the taxpayer for foreign purposes differs from the entity treated as earning the income for U.S. purposes. The purpose

of these rules is to match the income with the associated tax for U.S. tax purposes.
- This may arise, for example, where income is earned by an entity that is fiscally transparent (e.g., a partnership) for foreign tax purposes but that is treated as a separate corporation for U.S. tax purposes.
- This can also arise under foreign rules governing the taxation of affiliated groups (e.g., one entity pays the tax on behalf of the entire group; or losses are "shared" within the group).
- There also are rules designed to address "base differences"—i.e., the tax base for foreign purposes differs from the tax base for U.S. purposes.
- Foreign tax credits are computed on a pooled basis for CFC's (with foreign tax redeterminations treated as adjustments to the pool) and on an accruals basis for U.S. taxpayers and for foreign branches of U.S. taxpayers.
- Excess foreign credits are carried forward up to 10 years.
- There are complex rules governing losses—e.g., generally, if a net foreign-source loss reduces U.S.-source income in one year, subsequent foreign source income is re-characterized as U.S.-source income. A similar rule is applied if a net loss in one foreign tax credit basket offsets income in another basket, or if a net U.S.-source loss offsets foreign-source income in a year.

Interest allocation: There are highly detailed and complex rules governing the allocation of U.S. interest expense to U.S.-source and foreign-source income—e.g., 861, 864. These rules apply under current law for purposes of computing net foreign source income in connection with foreign tax credits. They also form the basis of the interest-allocation proposal in the Administration's budget, denying deductions for U.S. interest expense allocated to earnings of foreign subs (or branches) that are not subject to U.S. tax.

- Subject to certain exceptions, Interest expense is allocated to U.S. and foreign-source income based upon the relative value of the U.S.-group's U.S. and foreign assets. Income allocated to foreign assets is then allocated among assets within each foreign tax credit basket.
- The value of U.S. and foreign assets is generally determined by the U.S. tax basis in the assets. Taxpayers may elect to determine the value of assets based upon fair market value—which is a complicated and costly analysis.
- In many cases, a complex analysis is required to determine the type, or split, of income produced by an asset (e.g., an intangible).
- There are some complex (and incomplete) rules addressing the treatment of certain types of interest equivalents, including derivatives entered into as hedges.
- There are complex rules addressing the treatment of intercompany funding.
- These include the so-called "CFC netting" rule-designed to limit the creation of net foreign-source income through the combination of U.S. borrowing and intercompany funding (i.e., U.S. interest expense is allocated between U.S. and foreign income, and U.S. loans to foreign subs generally produce all foreign source income).

Subpart F rules: There are highly detailed and complex rules providing for the current U.S. taxation of certain types of income of a CFC—e.g., IRC 951–961. This is generally income considered to be passive or highly mobile.

- This includes so-called "foreign personal holding company income"—e.g., dividends, interest, royalties, rents and other similar income.
- There are complex rules for excluding such income from taxation, when derived in the course of an active foreign business. One such provision, the "active financing exception," is part of the set of "expiring provisions" that have needed to be reenacted on a regular basis.
- Under another "expiring provision," the "CFC look-through" rule, dividends, interest, royalties and rents paid between CFC's are excluded from Subpart F if allocable to underlying earnings that are not taxable under Subpart F.
- Current taxation under Subpart F also applies to so-called "foreign base company sales income"—which is generally income of a CFC derived from (i) the purchase of property from a related person or the sale to a related person, (ii) where the property is manufactured outside the country in which the CFC is located and the property is sold for use or consumption outside the country.
- There are complex rules for determining whether the property has been "manufactured" in the country where the CFC is located—e.g., whether the CFC has made a "substantial contribution" to the property.
- And, there are rules for determining whether the property has been sold for "use or consumption" in the country where the CFC is located.
- There are also complex rules applying similar principles to branches of CFCs.

• Similar taxation applies to "foreign base company services" income.

Comment:

If the U.S. adopted an exemption system (without a foreign minimum tax), the complexity of the foreign tax credit rules would be eliminated, except to the extended needed in connection with continuing Subpart F rules (discussed below).

Similarly, complexity would be avoided if the exemption system did not include interest allocation as a limitation on the deductibility of interest expense. In part because of concerns about complexity, many countries have opted for an exemption "haircut" (e.g., 5% inclusion) in lieu of expense allocation.

Under an exemption system, there likely would be a continuing need for the current taxation under Subpart F of passive foreign personal holding company income. However, it's questionable whether the foreign base company sales or services rules should be retained on foreign-to-foreign transactions (i.e., the transactions result in a reduction of foreign tax, not an erosion of the U.S. base). This would be another area where complexity could be eliminated.

#8

The "straddle" rules of Section 1092, which govern offsetting positions. Especially complex are the "mixed" straddle rules, where one of the offsetting positions is marked to market.

The New York State Bar Tax Section did a report in 2002 with some examples of unnecessary complexity. It's at the following link.
http://old.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/1007report.pdf.

They mention two more examples—the "fractions rule" and the rules for netting capital gains.

#9

The rules for corporate tax, partnership tax, tax accounting, and insurance tax are other examples of extremely complicated tax rules. Indeed, if I were asked to name the single most complicated and difficult rule in the U.S. tax system, I might name the rule on "deferred intercompany transactions" under the regulations for consolidated tax returns (the rule in Reg Sec. 1.1502–13). The standard treatise on consolidated tax returns devotes approx. 400 pages to the discussion of this single rule (the author of the treatise, an extremely capable and talented tax lawyer, wrote the rule when he was at Treasury's Office of Tax Policy).

#10

There are a lot of insanely complicated corporate tax provisions, but those usually don't get much sympathy because they mostly affect corporations that hire Big 4 accounting firms to work out the results. As to individual tax returns, but two obvious cases are the individual alternative minimum tax and the passive loss rules (for the high earners) and the earned income tax credit (for the low earners). Even the AMT and passive loss rules don't get a lot of sympathy because TurboTax automatically deals with a lot of the complexity.

#11

Section 382 and its regulations are extremely complicated. To determine whether use of a corporate NOL, capital loss or credit carryover is limited, you have to determine if there was an ownership change of the loss corporation, which is basically a more than 50% shift in ownership over the prior 3 years. To determine if there is an ownership change, you have to identify all 5% shareholders and determine if their equity interest has increased in the past 3 years and by how much. But if a corporation is owned by another entity or entities, you have to look through the upper entities to look for 5% shareholders and their ownership shifts. Besides the difficulty of finding out who owns an upper tier entity (if that is possible), there is a rule that says all less than 5% shareholders are together treated as a single 5% shareholder whose ownership has to be tracked, but in some cases you need to segregate these public groups into smaller groups and track the smaller groups. Identifying and tracking ownership shifts under the rules is very difficult, but the stakes are enormous, because if there is an ownership change the use of attributes can be severely limited or nearly wiped out.

To add to the complexity, the rules apply not only to NOLs, but also built-in losses. If a corporation has assets with overall basis greater than FMV, and it undergoes an ownership change, then if the built-in losses are recognized within 5 years after the ownership change, use of those losses are limited. So at the time of the ownership change you have to know if the corporation has an overall built-in loss and you have to know, for every asset you sell at a loss within 5 years after the ownership change, whether that asset had a loss in it at the time of the ownership change and the amount of that built-in loss at the time of the ownership change.

And then there is the application of the section 382 rules in a consolidated group. What a combination of two incredibly complicated areas. Just scratching the surface of the additional complexity, for example you need rules for members coming into and leaving a group. There are few people who really understand the consolidated section 382 rules.

I also note that there are special AMT rules if a corporation undergoes an ownership change.

Practice of tax law has gotten to the point where it is nearly impossible to be a generalist. There is too much to know and it's too hard to understand. It's not just federal tax law, it's state and foreign tax law too.

And if you think it's hard for practitioners, think about how hard it is for the IRS, which has to administer the entire Code, including such varied programs as the EITC, energy provisions, FATCA and healthcare.

#12

Complexity is relative. Different situations merit different levels of complexity; and the question is whether the rules are unduly complex for the specific situation.

Take the U.S. partnership rules, for example. Over the years, aspects of the partnership rules have been criticized for being overly complex; and the IRS has issued revisions to the rules in part in response to such comments. Much of the complexity in the partnership rules, however, pertain to special allocations of income/losses. The rules could be simplified by limiting special tax allocations. However, the business and investor community would presumably object because this would take away one of the principal benefits of operating in partnership form.

Financial products is another area with complex rules. Here again, there has been some criticism of the complexity of the rules. However, the subject matter is very complex. A bigger issue with financial products is that the products continually evolve; so there is a constant issue of the rules needing to "catch up" with today's products.

One issue that this discussion raises is the choice between alternative types of rules. At one end of the spectrum are very detailed rules applicable to specific fact patterns. This approach provides certainty in the results of the fact patterns addressed, at the risk of leaving open the treatment of other fact patterns. At the other end of the spectrum is a limited set of rules that represent guiding principles to be applied to different fact patterns. This approach provides flexibility to address a broad range of fact patterns, with less certainty in results.

It's interesting, because the consolidated return rules mentioned in Marlin are, in concept, an example of the second type of rules. They are designed to provide a limited set of guiding principles to govern the taxation of intercompany transactions within an affiliated group. However, the rules contain so many examples that the examples have come to be viewed as largely defining, as opposed to illustrating, the rules.

As far as complexity in the context of the international tax rules: international business operations are complex, which suggests some unavoidable level of complexity in the international rules. However, there seems to be an opportunity to reduce the complexity in changing to a new (exemption) system—which achieves other benefits as well.

#13

There are certain parts of the tax code that are "complex" in the sense of being very difficult because of certain conceptual challenges. Subchapter K is a good example in my view. The total quantity of rules is not great, especially when compared to other areas of the Code. Instead, the complexity is generated largely by the fun-

damental tensions between the aggregate and entity theories of partnership and how that tension makes it so difficult to resolve a number of issues (plus there are many issues that simply lack guidance). This is difficult material to be sure, but not "complex" apart from the extreme difficulty.

Another strain of complexity is found in areas of the Code which are very formalistic and often contain multiple traps for the unwary. Section 305 (stock distributions) is like that, as are a number of the reorg provisions in subchapter C (which can be exceedingly formalistic).

Perhaps more relevant are areas of the Code where there are these intricate rules upon rules. These are areas where, instead of wiping the slate clean and starting over again, Congress and/or Treasury continues to layer floors and floors of rules upon a fundamentally shaky foundation, so that the end result is a maze of rules that are very hard to navigate. I think Section 382 (the section on trafficking in NOLs) is one example—is that really such a big problem that we need hundreds of regulations to combat it? But I think perhaps the best example is the foreign area, where the entire process with Congress and Treasury seems to be one giant "whack a mole" exercise. The 7874 rules that we discussed is a good example (with it having gotten so bad that folks are now worried that totally innocent cross-border transactions that aren't meant to be inversions can nonetheless get caught by 7874). The 367 rules governing cross-border reorgs are a monument to complexity—hundreds of pages of temp and regular regs that do not mesh well at all and are remarkably confusing. The foreign tax credit rules are another area, especially after the 909 splitter and 901(m) restrictions came into law.

#14

What I find perplexing is that the Code is riddled with complexity even for basic fact patters affecting the general taxpayer. It's hard to build trust in the tax system when the average American needs to hire an outside professional to prepare his/her tax return. I have prepared tax returns for low income taxpayers who have to navigate complicated rules such as the definitions for single/head of household, dependents/qualifying persons, earned income credits and the litany of other rules that should be basic law for someone who clearly has no financial background. And, this permeates the entirety of the Code. It affects us all because it feeds the notion that the tax law is rigged and only benefits the business or person who can retain high priced talent to benefit from "loopholes" in the system.

#15

1. Allow small business greater use of the cash method of accounting. The Bush Treasury allowed the use of the cash method to a wide swath of small businesses. The Obama budget has proposed expanding it to businesses with up to $25 million of receipts. It would allow many small businesses to file their taxes with little more than their checkbook registers of bank statements.
2. Increase small business expensing. The Obama budget takes the expensing limit up to $1 million. Combined with use of the cash method, this proposal would represent significant simplification for small business.
3. Repeal the uniform capitalization rules of section 263A and replace with book capitalization rules. This one wasn't allowed out of the building. Revenue estimators insisted it would lose revenue. The accounting experts at Treasury insisted section 263A loses revenue because it invites companies to redo their book capitalization, which inherently favors capitalization, and to expense everything they possibly can.
4. Combine the multitude of tax preferred savings accounts into two simple accounts, one for retirement savings and one for everything else. We called the retirement account simply "retirement savings account" and the all-purpose account "lifetime savings accounts." The accounts attracted more excitement than any proposal I've ever worked on from Ph.D. economists to ordinary Americans. I believe the proposals would have been hugely beneficial for families of moderate means because they were simple to understand and didn't require that funds be set aside untouchable except for particular purposes, which deters moderate income individuals from using tax preferred savings vehicles at all.

#16

Foreign tax credit provisions are incredibly complex. To claim a foreign tax credit a firm has to (1) determine the payment to the foreign government is a "tax" (i.e., a mandatory payment that is generally applicable and for which it does not receive

a "specific economic benefit"), (2) that the tax is an "income tax" in the U.S. sense (i.e., you must apply U.S. tax principles to foreign law to see if the tax is based on net income), (3) you must then determine the amount of your (a) foreign source gross income and (b) your foreign source deductions (by following a series of extremely complicated rules set forth in the regulations . . . including separate allocation rules for separate kinds of income—e.g., interest), (4) allocate the foreign source income and foreign source deductions among various "baskets" (passive, active, high tax, oil related, etc.), (5) subtract the allocated expenses in each basket from the income allocated to that basket to determine the foreign source taxable income in that basket, (6) determine the ratio of the foreign source taxable income in each basket to worldwide taxable income to determine whether there is a limit that applies to the allowable foreign tax credit, and (7) work through any carry overs or carry backs of excess foreign tax credits from prior years . . . and all the while make sure you are on the right side of a broad set of anti-foreign tax credit stripping rules that require an entity-by-entity determination of current income and deductions, and historic pools of earnings and profits.

By contrast all of this complexity disappears under a territorial system.

#17

The complexity of some of the U.S. rules—e.g., regulations relating to interest expense allocation—creates at least as much difficulty for the IRS as for taxpayers and leads to real questions about administratibility and fairness. Policymakers should have this in mind in the context of tax reform, or in connection with multilateral initiatives such as BEPS (where unadministrable rules can lead to double tax and cross border disputes).

#18

A few of the areas of areas of complexity worth noting are:

(1) The dual consolidated loss rules. It is a relatively brief statute found at section 1503(d), but the regulations ate 1.1503(d)–1 through –8 are (as the citation suggests) very extensive.

(2) The overall foreign loss ("OFL"), separate limitation loss ("SLL"), and overall domestic loss ("ODL") rules are another good example of complexity (and maybe an even better example of how complexity inevitably breeds further complexity). You start with a foreign tax credit system to prevent double taxation (which sounds simple enough), but then you need FTC limitation rules to prevent using credits to offset tax on U.S. income; that requires a universe of income sourcing rules (a subject for another time). Then you need different baskets of foreign source income to prevent "inappropriate" cross-crediting (and of course the number of baskets has ebbed and flowed over time as perhaps further evidence of the battle between "precision" and "complexity"). Once you have baskets and FTC limitation rules you need OFL and SLL rules to preserve the integrity of those categories "across time." So taxpayers need to track all their different items of income, "source" them, "basket" them, and then track those categories over time using multiple OFL and SLL accounts, with the result that once you have sourced and basketed income you may have to re-characterize that income in any given year based on what happened in prior years. Having done all that for foreign losses to backstop the FTC limitation rules, it's only fair to have overall domestic loss rules to ensure that taxpayers aren't inappropriately denied credits over time. So the ODL rules are introduced into the Code. And then you need extensive regs telling you how all these pieces are supposed to fit together. For citation purposes, the OFL and SLL rules are found at section 904(f) of the Code, the ODL rules are in section 904(g), and the regulations are all under 1.904(f)–1 through –12 and 1.904(g)–1 through –3.

(3) Another set of rules that we didn't discuss, but which are extensive, everchanging, and complex are the regulations under section 367. That Code provision is basically meant to override or turn-off the non-recognition rules in certain cross-border transactions, and the regulations under those rules are voluminous (to say the least), with several outstanding Notices describing yet more regulations to be written under those statutory provisions.

#19

The number of tax brackets is not a source of complexity in itself in an era of e-filing (though the lumpy effective marginal rate schedule probably is), even though that's where the political rhetoric goes. Also, the realization requirement, coupled

with 1014, is perhaps the biggest single source of complexity. It creates huge differences based on character and timing, and so we then have numerous provisions to police it. If we had mark-to-market, we could get rid of a corporate tax, get rid of constructive sale rules and associated planning, tax accrued gains at the same rate as ordinary income (thus minimizing character issues), stop a lot of the debt/equity issues—maybe even get rid of the estate tax, if we are otherwise effective at taxing inter vivos wealth accumulation. So when people say mark-to-market is "too hard" or "too complex," I'm confused.

Here are some specifics on education. So many overlapping and conflicting provisions that I think it's hard for a taxpayer to plan effectively, and as a result I'm skeptical that these have much incentive value. I think they are likely just pure redistributive transfers, likely shared with the institutions.

- Section 222 provides an above-the-line deduction for qualified tuition, but only in certain situations, and with discontinuous income-based caps and no phase-out or inflation adjustments
  - The allowed deduction is also limited in cases where the Section 25A credits apply and where the tuition was paid out of a 529 account.
- Section 25A provides for two somewhat overlapping tax credits, the Hope Credit and the Lifetime Learning Credit, with different benefits, applicability, eligibility, and inflation-adjusted phase-outs.
  - These are somewhat simplified by temporarily making the Hope Credit more generous (larger, refundable, slower phase-out) and renaming if the American Opportunity Tax Credit under § 25A(i), but that expires 2018, so it will be subject to the typical extender nonsense, probably not being resolved until after students make expenditure decisions.
- There are multiple forms of education savings accounts, each with their own kludgy rules.
  - 529s create gift tax issues and allow trades only twice a year. § 529(b)(4). I assume that's for paternalistic reasons, but it also stops appropriate rebalancing.
    - The state/federal structure is weird too.
  - There are also Coverdell Education Savings Accounts under § 530, with different rules, definitions of applicable expenses (private school, not just college), more investment flexibility, but income limitations that 529s don't have.
- Let's throw in loans and financial aid while we're at it:
  - Pell Grants and subsidized loans that require different eligibility determination, using FAFSA instead of tax return
  - But IBR and PAYE loans also, which do use tax return information.
    - These also have political risk, including whether or not forgiveness will be taxable.
  - Plus loan interest is deductible in some cases, under § 221, but with income phase-outs, etc.

#20

Section 382 and the regulations is one of the most complicated tax provisions.

Others that rank high in complexity:

1. Almost any Code section that requires resort to the Section 318 attribution rules, which apply to 8 other Code sections, per the Code, and are incorporated by reference in some additional places in the regulations.
2. Section 367, which changes/affects the result in exchanges described in sections, 332, 351, 354, 356, or 361, as well as certain other cross border or outbound transfers. subject to exceptions included in the Code and the regulations, special rules for partnerships, special rules for deeming certain transfers to be "exchanges," and special rules for transfers of intangible property within the meaning of section 936(h)(3)(B).
3. Section 409A and a voluminous set of regulations which sets forth some extremely complex rules governing the timing, form and tax treatment of nonqualified deferred compensation payments. (For example, the rules require meeting specific requirements related to the time at which the initial decision to defer the compensation is made, prohibiting any later changes to the timing of the payments (i.e., they can't be further deferred unless very strict rules are met, and they cannot be accelerated), limiting the time at which payment can be made to certain fixed events or dates, including death, disability, termination of service, change of control, or a fixed date set at the time the plan

is adopted. . . . and each of these payment dates (other than "death") has its own set of complex definitions, rules and requirements.)
4. Alternative minimum tax for individuals.

Other sources of complexity for individuals include phase outs, the multiplicity of rules applicable to pension and saving plans (e.g., traditional IRAs, Roth IRAs, profit-sharing and employee stock option plans, 401(k) and 403(b) plans).

#21

1. Limitations on the foreign tax credit.
2. The application of subpart F to partnerships
3. Expense allocation for purposes of determining the allocation of deductions to foreign source income (relevant for foreign tax credit limitation purposes).
4. Complex in a different way: application of the various anti-abuse rules and doctrines in the code and case law, including the economic substance doctrine.
5. The withholding and reporting rules on cross border payments, including but not limited to FATCA.

PREPARED STATEMENT OF T. KEITH FOGG, PROFESSOR OF LAW AND DIRECTOR, FEDERAL TAX CLINIC, VILLANOVA UNIVERSITY SCHOOL OF LAW

GETTING CORRECT RETURNS

For low income taxpayers any trip into the arena of tax controversy amounts to a loss. In general, they do not have the ability to successfully navigate the tax controversy system. This system, however well-intentioned and layered with protections, does not serve them well. If low income taxpayers end up in the controversy system after receiving a refund, the IRS also does not fare well. Even if the IRS establishes a deficiency in tax, it will struggle and generally fails to collect the tax once it goes out the door to a low income taxpayer.

Refundable credits create the greatest area of concern for low income taxpayers, the IRS and the system in general. The decision to use the tax system as a delivery mechanism for benefits places a great strain on the tax system because it was not designed for this purpose. The siren song of obtaining money from the government for the cost of submitting a return, refundable credits, used to benefit low income taxpayers, bring out identity thieves and fraudulent preparers who prey on low income taxpayers and the IRS. The actions of these thieves, bad preparers and fraudulent preparers draw low income taxpayers into the controversy system and greatly complicate their lives. Once the IRS begins the examination process, low income taxpayers must react appropriately to a host of letters and notices that bewilder them. Avoiding this situation provides a path to simplifying the system for taxpayers who generally do not have the skills to protect themselves.

To simplify the system and the interaction between low income taxpayers and the IRS, I would place great emphasis on getting it right at the return filing stage. Instead of building a system designed to issue a refund as quickly as possible and then deal with the consequences of mistakes or fraud through the tax controversy system, the system should emphasize competent tax return preparers or well-designed software programs coupled with document matching to make sure that the right amount of tax gets assessed at the outset and the right amount of refund gets issued. If the returns received by the IRS contain correct information and if the IRS processes those returns at a time when it can verify the correctness of the information reported on the returns, then identity thieves will no longer use the return process as a source of revenue. If preparers are properly regulated, particularly ones preparing returns with refundable credits, low income taxpayers will not be victimized by the preparation process and wind up in the controversy system.

In placing emphasis on the return filing point as the most critical point in the tax system, my colleague, Les Book has put forth principles that should guide decisions on how to the return process:

Does the provision promote desired behavior?

How does it relate to other provisions also intending to promote compliance?

What are the taxpayer and third party costs?

Are compliant taxpayers/preparers bearing too high a cost?

Are the "right" noncompliant parties being identified?

Is the administrative determination readily susceptible to challenge?

Does the provision allow IRS to efficiently administer its scarce resources?

Is compliance readily ascertainable?

DESIRED BEHAVIOR

We want taxpayers to file accurate returns. We want to stop identity thieves by making the return filing process unproductive for them. We want return preparers or return preparation software to perform in a manner that makes them the gatekeepers to the system and assists taxpayers in navigating the system with the least cost and inconvenience.

RELATIONSHIP TO OTHER PROVISIONS PROMOTING COMPLIANCE

We want a filing system that stops submission of incorrect data without moving the matter downstream into the compliance system except in rare cases. With respect to identity thieves, a system of matching information prior to issuance of refunds will generally stop the theft. Once the system demonstrates that filing the return does not bring the desired reward, thieves will abandon the filing system unless and until they can identity another opening. Delaying the issuance of refunds until data matching occurs should significantly relieve downstream pressure on compliance.

TAXPAYER AND THIRD PARTY COSTS

Costs go beyond time and must reflect characteristics of community being regulated. Low income taxpayers rely on their refunds to pay bills. Delaying the refunds will delay bill payment. While the delay to build a matching system brings a one-time delay not felt in subsequent filing seasons, the timing of the refund can have other consequences. Delaying the refund annually into the late Spring or early Summer could impact the ability to pay certain time sensitive bills such as utility bills for heat. Coordination with those providers and with other providers on time sensitive matters would need to be a part of the equation of moving the refund period.

Placing greater regulation on preparers would drive up their costs and the cost to taxpayers using their services. The additional costs may need to be considered in determining the amount of the refundable credit in order to enable and incentivize taxpayers to utilize more qualified and diligent preparers.

COMPLIANT TAXPAYER COSTS

The goal is to eliminate the reward that currently exists for thieves and remove incompetent or fraudulent preparers. Return preparation costs may increase and the refund may come later in the filing season. Both changes could negatively impact compliant taxpayers who have not had difficulties with the present system. Providing some basis for offsetting the return preparation costs could take care of the first problem. With greater savings from greater compliance, perhaps a basis for providing taxpayers with this financial cushion exists. Allowing a quicker refund to taxpayer using certain certified preparers may eliminate the delay in receipt of the refund and provide additional incentive to use qualified preparers.

IDENTIFYING THE RIGHT NONCOMPLIANT PARTIES

The noncompliant parties are known. Identity thieves will struggle to profit in a system that tests information on the return against third party data and returns filed by the "real" taxpayer prior to sending out a refund. These individuals should largely get blocked from refunds eliminating their incentive for filing and perhaps reducing the number of returns filed once the matching system gains full impact. Fraudulent preparers should have much greater difficulty operating in a regulated system. If the IRS has authority to police the return preparer population, it should largely eliminate the unscrupulous preparers without the need to file injunction suits that stop people after they have prepared inappropriate returns. The IRS also needs to develop a more effective system for assisting taxpayers from preparers who do get past the regulation and steal from them.

CHALLENGING THE SYSTEM

A system must exist for pushing back against the determination by the IRS that has understandable legal standards—both to IRS and taxpayer. Even though a well-defined and well administered tax controversy system exists today, it places significant barriers to success for low income taxpayers because it avoids human contact

and relies almost exclusively on correspondence and telephone contacts. This method of addressing the problem does not work well for many low income taxpayers who simply avoid and ignore a system not designed for their problem solving skills.

Low income taxpayers need an accessible and clear way to communicate with IRS about determination. Many times that way should involve in person contact, but such contact does not exist for low income taxpayers until they get to the Appeals Office or to Tax Court. The IRS assigns individual agents to work larger cases involving sophisticated taxpayers who could navigate the maze of phone and computer options, but sends low income taxpayers to deal with employees in phone banks who only touch the case once and cannot develop a connection with the taxpayer. The system itself of requiring the least sophisticated users to endure the most impersonal process creates many of the problems for low income taxpayers. In both the examination and collection phases of their case, low income taxpayers go from start straight through to levy without a person assigned individually to their case. They simply receive a series of letters requesting information or directing action but they never hear from a person. These letters provide little meaning or context to the problem for many low income taxpayers and end up in a drawer or in a trash can.

Low income taxpayers need a clear path to court review of administrative determination. The IRS provides them with information in the correspondence it sends but makes it very difficult for them to speak to someone who can explain the process or answer their questions. They must wait for an hour or more to get through to someone on the phone who may or may not have good skills at explaining the process and guiding them to the steps they need to take to challenge a decision and preserve their rights. The system relies on taxpayers understanding and exercising their rights yet it has, through refundable credits, picked up a populace with great difficulties in doing so. The IRS has made some accommodations to assist these taxpayers after they fail to properly exercise their rights, e.g., audit reconsideration; however, it uses the system built for more sophisticated taxpayers to serve this population. Neither Congress nor the IRS has not tried to build a system designed to meet the challenges of this population that were placed without request into the federal tax system.

EFFECTIVE USE OF SCARCE RESOURCES

As the IRS tries to manage more and more taxpayers and tax issues with fewer and fewer resources, it seeks to rely more and more heavily on automation and impersonal contact. This is a logical use of scarce resources except that it often fails the low income population which cannot adapt to systems and processes developed by the IRS for more sophisticated users. While marshalling its resources for effective use, the IRS and Congress must acknowledge that some taxpayers simply need a personal touch. Sending letters, citing people to Internet sites and having phone lines that do not get answered for long periods does not serve a populace that cannot hire representatives to assist it with the process and does not have the knowledge to navigate the system effectively. A different system for using resources needs to emerge even if it means fewer resources to do other tasks.

Having said this, the best use of scarce resources is preventing problems in the first place by putting great emphasis on the correctness of the return and enlisting return preparers and software manufacturers to aid in the correctness through a mixture of regulation, behavioral science and matching. At the outset of the case, the IRS could rely on its computers and on outside resources to try to prevent taxpayer problems that will draw upon its limited human capital. Through this method, which may involve delaying the timing of refunds to maximize the correctness at the outset, the IRS can more effectively use its scarce resources. One model for using outside resources to help insure the correctness of returns involves some form of certification of the correctness of returns seeking refundable credits. A certification process exists in the ITIN area for taxpayers seeking an identification number:

One proposal to assist the IRS that has recently emerged involves expanding the math errors procedures using the name correctable error. This proposal raises concerns because it focuses on the back end of the return process rather than the front end and it removes rather than expands rights of low income taxpayers. It does address the scarce resources concern at the IRS and seeks to truncate the audit process but it does so at a cost to taxpayers who may have a legitimate claim which may get lost in the new shorter process.

SUCCESSFUL COMPLIANCE OUTCOMES

The most successful compliance outcome for low income taxpayers results from keeping them out of the compliance process as a result of their own mistakes or the willful or mistaken conduct of others such as identity thieves or fraudulent preparers. While minor improvements to the process might exist and will receive attention below, none of these improvements will create a compliance process that will work well for low income taxpayers.

To sum up this section of operating principles, I recommend certain possibilities as a possible application of the principles as they apply to returns containing refundable credits:

(1) Require a form of pre-certification of the returns and do this through preparers who have obtained certification from the IRS or through approved software programs;

(2) Do not allow preparers who have not obtained the proper approvals from the IRS to prepare returns with refundable credits;

(3) Do not issue refunds to taxpayer seeking refundable credits to those who do not use properly approved preparers or properly approved software until after the IRS has the opportunity to load matching data and cross check the accuracy of the data on the returns (or do not allow any refundable credit refunds until the matching has occurred);

(4) Acknowledge that accuracy and not speed is the key to the successful filing experience of a low income taxpayer seeking a refundable credit;

(5) Provide some financial incentive to taxpayers to use the properly authorized preparers or software to compensate for the additional cost incurred

Other Provisions That Would Assist Low Income Taxpayers in Tax Compliance

PROVIDE AUTHORITY FOR THE IRS TO REGULATE PREPARERS

Clinicians operating low income taxpayer clinics see day in and day out the ravages that poor and unscrupulous preparers cause to our clients. The return preparation stage is the most important moment in the process for low income taxpayers who do not have the resources or savvy to engage effectively in the tax controversy process. Reverse the decisions in *Loving v. United States* and *Ridgely v. Lew* and allow the IRS and Treasury to regulate the industry that has such an important impact on agency actions and on taxpayers in general. As mentioned above concerning walk in sites, if we must bring low income taxpayers into the tax filing system in order to obtain benefits, we need to make sure we have designed a system that does not prey upon them. By creating refundable credits, the system attracts individuals motivated to get that easy money. These credits have created a paradigm shift in the return filing process that must be acknowledged. The IRS finally acknowledged the problem only to have its efforts stymied by the Courts. Congress needs to step in to protect low income taxpayers and the system in general.

PROVIDE A WORKABLE FRAMEWORK FOR ASSISTING VICTIMS OF FRAUDULENT PREPARERS

We brought low income taxpayers into the tax system to deliver benefits causing them to prepare, or have prepared, tax returns with sufficient complexity to create problems many cannot navigate without assistance. When the low income taxpayer has the misfortune to choose the wrong preparer among the many unregulated preparers, these taxpayers are being stuck not only without their refund but with the bill created by the fraudulent preparers. The IRS has the authority to abate taxes on fraudulent returns in which the taxpayer did not participate and to refund to the taxpayer the correct amount of tax the taxpayer should have received had the taxpayer not been defrauded. The IRS has significantly dragged its feet in assisting these individuals.

After being defrauded and not receiving their refund or receiving their refund and then being placed in the audit system, these victims must endure audit process and wait years seeking resolution. The adoption of a better filing system described above should eliminate many of these problems going forward, but at this time many low income taxpayer sit in victim's purgatory awaiting disposition of their cases. The IRS is not moving on their corrected returns and has placed the most vulnerable population of taxpayers in an untenable position. If a taxpayer can demonstrate that

they are the victim of a fraudulent preparer, the IRS should establish a system of quickly moving to assist them to remove assessments from their account and to restore their correct refund. They should not receive bad treatment because they are poor and made an unfortunate choice in the unregulated marketplace of who to trust to prepare a return they do not know how to prepare themselves.

PROVIDE TAXPAYERS FIGHTING IDENTITY THEFT AND FRAUDULENT RETURN PREPARATION WITH ADEQUATE INFORMATION

The IRS interprets the disclosure rules in a manner that can make it very difficult for taxpayers victimized by identity theft to obtain information about the theft of their identity and defend against the consequences. If a taxpayer informs the IRS that a return using their identifying information did not originate from the taxpayer, the IRS declines to provide the taxpayer with that return citing the disclosure laws. The disclosure laws should allow a taxpayer access to documents using their tax identifying information. The ABA Tax Section has proposed a legislative change that would address this problem and allow individuals access to tax returns using the tax identification number of the individual. A prior legislative proposal also sought to address the problem although it placed discretion in the IRS to release the information. Taxpayers whose identities have been stolen need access to the information concerning use of their personal information. The disclosure laws came into existence to protect taxpayers and not to leave them uninformed and unprotected.

ASSIST LOW INCOME TAXPAYERS IN MEANINGFUL WAY WHEN THEY INTERACT WITH IRS

The IRS budget problems drive it to close sites where individuals provide assistance to taxpayers and cause it to seek to provide more services via the Internet. This does not work for many low income taxpayers who do not have the access or skills to get the information they need from the Internet. The IRS has not only closed or greatly curtailed its walk in sites but its phone wait times have increased to unmanageable proportions. Many low income taxpayers use track phones and do not have the minutes to wait for someone to come onto the line. If we decide to use the tax system as the delivery mechanism for certain benefits previously delivered elsewhere in the government, we must build a system that accommodates this population and not ignore the fact that we have introduced millions into the tax system that might not otherwise need to interface with the IRS. A part of using the tax system to deliver benefits must include the necessary infrastructure to service the population that does not operate as most taxpayers in the system. The IRS must receive the resources necessary to service this population in a meaningful way.

MOVE SLOWLY INTO PROCESS THAT REDUCES TAXPAYER RIGHTS

The concept of math error is rooted in a simple desire to quickly and easily correct a return where the taxpayer adds 2+2 and gets 5. That type of mistake deserves the treatment established in 6213 for a letter to the taxpayer explaining the problem and a short time frame for the taxpayer to point out their math was correct or allow assessment of the correctly calculated amount. From that simply concept has grown and panoply of provisions giving the IRS authority to make an assessment without giving the taxpayer the direct opportunity to go to Tax Court and contest the decision.

Recently, much discussion has centered on a further expansion of math error to allow the IRS to administratively create adjustments similar to math error now traveling under the more correct moniker of correctable error. A proposal to give the IRS authority to expand these provisions appeared in the General Explanation of the Administration's Fiscal Year 2016 Revenue Proposals at pages 245–256.

For the reasons discussed above, fixing problems at the return filing stage provides far better benefits to the system than fixing those problems at the back end. The correctable error proposal would allow the IRS to fix the problem at the end of the return filing stage as it would normally transition to the examination phase. It will reduce IRS resources in examining returns because it will allow the IRS to send a correctable error notice when data on the return does not match data in the IRS system.

Matching information before sending refundable credits should occur. The correctable error proposal does not seem designed to stop and correct the return prior to sending the refund. Although the IRS will freeze refunds in many instances as it does today, the correctable error proposal at its core appears to reduce exam resources for the IRS and truncate taxpayer rights.

Matching before refunding should also reduce examination resources. The goal of correctable error, in that respect, operates in sync with the goal of matching before refunding. The problem with correctable error comes with the truncation of taxpayer rights. A math error notice (and presumably a correctable error notice) does not come with the same explanations and rights as a notice of deficiency and does not come with the same time frame. A taxpayer must determine what the notice says and write back to the IRS within the 60 day time period in order to avoid having the taxes assessed. If the IRS matches documents before refunding, freezes any refundable credits (and possibly and paid credits) not lining up with the documents available to the IRS, the taxpayer should have the opportunity to test the difference in Court after a full and fair opportunity to respond to the IRS concerning the correctness of the items on the return.

The abbreviated protections afforded by math error should remain the exception and not the rule. The IRS should give taxpayers the opportunity for a meeting with an individual assigned to their case who can review the information and make informed determinations. The goal should be to swiftly make a determination because the taxpayer awaits a refund which is crucial to their financial well-being, However, swiftness should not mean an abbreviation of their rights.

While Congress has expanded math error authority over the years, it has done so in a slow and deliberate manner. As it expanded the math authority provisions Congress looked to ensure the benefits of reducing taxpayer rights justified the expansion of the math error authority. The correctable error proposal would pass that decision to the IRS. Erring on the side of giving taxpayers more due process protections by allowing them a day in Tax Court when a discrepancy exists regarding data follows a path that should not harm the IRS if it holds the money. Taxpayers engaged in identity theft or refund fraud are not likely candidates to call upon the IRS or Tax Court resources to resolve their problems. Once denied the initial quick refund, these parties will run and hide seeking to avoid further identification and detection. Taxpayers with legitimate concerns should get their opportunity to explain the correctness of their return with full rights including the presumptions created in IRC 6201(d) regarding third party information. These procedures will fall disproportionately on low income taxpayers who have the most to lose.

While we should look to create systems within the IRS that work for those brought into the tax system because of its use to deliver benefits, those systems should not seek to usher taxpayers out the door without the opportunity for the full measure of their rights.

QUESTIONS SUBMITTED FOR THE RECORD TO T. KEITH FOGG

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

Question. Mr. Fogg, you say in your written testimony that "[t]he decision to use the tax system as a delivery mechanism for benefits places great strain on the tax system because it was not designed for this purpose." Your testimony, however, then goes on to identify methods within the context of the tax system by which to alleviate the strain, such as pre-certifying returns, matching IRS data with returns, and slowing the refund process and timeline. However, I did not notice any mention of simply not delivering such benefits through the tax code and identifying an alternative delivery method. Are you therefore suggesting that the costs of delivering benefits through the tax code, including these new mechanisms you identified, are outweighed by the benefits? Additionally, would simplification of the tax code result from relieving the tax system of a burden for which it was not designed—the delivery of these benefits via refundable tax credits? Or are you suggesting that some modifications to the current system for low-income taxpayers will reduce complexity in the system and enhance compliance and administration?

Does delivering benefits through the tax code provide an overall benefit compared to another delivery system?

Answer. I did not mean to suggest that the costs of delivering benefits through the tax code are outweighed by the benefits because I have no basis for providing you with an informed judgment on the relative costs and benefits. Use of the tax system to deliver benefits can provide relatively low cost method of getting out money to low income workers when everything goes smoothly. Others have thought about and written on this subject from a comparative perspective. See, e.g., David A Weisbach and Jacob Nussim, "The Integration of Tax and Spending Programs,"

113 Yale L. Journal 955 (2004) and David Gamage & Darien Shanske, *The Trouble with Tax Increase Limitations,* 6 Alb. Gov't L. Rev. 50, 57 (2013).

My point related to the impact on the tax system of using it as a delivery mechanism for benefits and the impact of the use of the tax system on the beneficiaries. Too often we focus on the ease of pushing out the money without focusing on the back office operation that must accompany the delivery system. The impact on the tax system has many facets but I will focus on only a few. First, it requires the IRS to devote resources to a social benefit program rather than its core tax administration and collection function. If the IRS budgets shrinks but the social benefit program does not, a greater percentage of the IRS budget must necessarily be devoted to delivering social benefits compared with collecting and administering the tax system.

Second, using refundable credits as the mechanism for delivering the social benefits places a strain on the tax system because it introduces into the system an additional source of errors and noncompliance. Because of the refundable nature of these credits, they attract parties to the tax process seeking to obtain money through false pretenses and identity theft. These were not common problems in the tax system prior to the introduction of these credits. For more information on this issue see, Identity Theft: Trends and Issues, a report by the Congressional Research Service available at *https://www.fas.org/sgp/crs/misc/R40599.pdf.* If we choose to deliver benefits through refundable credits, we need a tax system built to identify false claims with a high degree of certainty. Having the IRS load available third party data prior to processing returns would create the necessary certainty to strongly combat the ID theft issue.

There is no research which suggest that the presence of refundable credits itself is a driver for traditional tax compliance issues. In addition to attracting identity theft, one problem with the earned income tax credit (that it shares with small businesses) the presence of variables that are not subject to information reporting, or visibility. The lack of visibility to the IRS in the earned income tax credit comes with the residence requirement. For more information on this see the article published by the American University Law Review available at: *http://digitalcommons.wcl.american.edu/cgi/viewcontent.cgi?article=1215&context=aulr*. This plays out with multiple parties claiming the same dependent. At present, the IRS generally allows the first person claiming the dependent to succeed while it blocks further persons claiming that dependent. Because of the lack of visibility caused by the residence requirement, the IRS operates blindly here giving the refund to the earliest filer and throwing later filers into the audit stream. Eliminating the race to filing that currently exists with the first filing successfully claiming the dependent could be significantly reduced by holding returns until the due date and then matching. While the residence issue will remain opaque to the IRS, it will now have the knowledge of all parties claiming the dependent at the time it goes to award the benefit. This will allow it to make a more informed decision.

Third, the noncompliance occurring with refundable credits becomes compounded by our visceral reaction to the payment of an improper refund as a more important dollar loss than the failure to identify underreporting of tax. This natural reaction seems to cause Congress to direct the IRS to spend more energy chasing after or preventing the lost refund dollars than much larger dollar issue surrounding the underreporting of tax. This further removes the IRS from its core mission of administering the tax system and collecting the most taxes with the least cost. Flipping the filing season in the manner I proposed would allow the IRS to more easily stop improper payment of refunds. This, in turn, would free up its resources to focus on its core mission rather than expend more time, energy and money administering a social benefit program.

Problems also exist on the taxpayer side of the equation when the IRS delivers social benefits.

First, low income individuals who would not become enmeshed in the complexities of tax law and tax procedure get brought into the system in order to obtain their benefits or as a result of improperly, or allegedly improperly, obtaining benefits. The decision to use the tax system as the delivery mechanism should include thought about the difficulties these individuals will encounter as they interface with a system not designed with them in mind. One example of the difficulty of merging the tax system and the social benefit system occurs in the refund arena. The tax system has a long held rule requiring full payment before a refund suit may be brought. The full payment rule stands as a significant barrier to access to the judicial system for low income taxpayers caught up in a dispute with the IRS over the correctness

of the earned income tax credit where the taxpayer misses the opportunity for judicial review in the only pre-payment forum, the Tax Court. I have written on this topic previously for my blog, which is available at *http://www.procedurallytaxing.com/refund-suits-divisible-taxes-and-flora-when-is-a-representative-payment-representative-enough-part-1/*.

Second, the tax system provides a significant burden to the low income taxpayer when the IRS has inadequate staffing to handle the issues created by placing social benefit programs on its plate. The phone wait times to reach the IRS this year are extremely long and provide a significant barrier to anyone who does not have significant blocks of time during the hours when the phone lines operate and who does not have unlimited minutes on their phone plan. The IRS does not have convenient walk in locations, hours, staff, etc, to allow low income taxpayers to walk into the IRS and sit down with someone to discuss their problems. Due to its staffing problems, the IRS tries to push out information through its web site; however, Internet access and usage capabilities provide significant barriers to many low income taxpayers who might want to make use of this resource. The IRS has proposed further expansion of its math error authority which will further reduce the protections of taxpayers brought into the tax system. In short, low income taxpayers receiving benefits from the tax system have no one to talk to when the system does not work and the IRS seeks to further cut off their rights. If we use the tax system to deliver these benefits, we must provide adequate resources to the IRS to service this population as well as adequate protection of their rights.

Third, forcing low income taxpayers to obtain their social benefits through the tax system causes a high percentage of these individuals to use paid tax preparers at a high cost to them because of the real or perceived complexity of the tax system. Rather than working with someone at a government office who does not charge for processing the request for benefits, low income taxpayers receiving the benefits through the tax system who lack comfort with the filing process must use paid preparers (unless they can find a VITA or AARP volunteer.) These preparers are currently unregulated and may prey on low income taxpayers. Even when these preparers operate with ideal practices, return filing and ancillary fees can significantly dilute the benefit delivered. For more information on this point see *http://www.nclc.org/images/pdf/pr-reports/report-tax-time-products-2015.pdf*.

My concerns with the current system can be addressed if we work to eliminate the opportunities for improper claiming of refundable credits by having the IRS load third party data prior to processing returns. This should stop a high percentage of the improper claiming of benefits from turning into refunds that the IRS must chase after in a process that further dilutes its resources from core tax administration and collection. On the taxpayer side, we should acknowledge that the cheap cost of sending out money through the tax refund process comes with back-end costs that need to be funded even if the IRS budget is simultaneously being reduced. Phones lines must be properly staffed, convenient walk in offices should exist both to assist in return preparation and in responding to problems. Additional grants to promote volunteer preparation or direct grants to assist in financing proper return preparation should become a part of the system of delivering these benefits through the IRS.

Question. Would simplifying tax code relieve the system of the burden of delivering benefits?

Answer. Yes, simplifying the tax code could reduce the burden on the tax system of delivering benefits through it. My previous written and spoken remarks focused on simplifying the tax code as it pertains to procedure and I will continue to focus on that aspect in my written remarks; however, it is also true that simplifying the code to make it easier to identify and claim the benefits would also help. For more information on EITC issues see articles by the Joint Committee on Taxation available at *http://www.cob.sjsu.edu/nellen_a/papers/EITCReform.pdf* and a by the Center on Budget and Policy Priorities available at: *http://www.cbpp.org/cms/?fa=view&id=3445*.

The primary focus of my remarks on simplification concerns changing the focus of the return filing process from one designed to pay refunds as quickly as possible to one designed to obtain the best possible return and return verification process. Focusing on the correctness of the return could greatly simplify the system for low income taxpayers and the IRS by getting it right at the outset and avoiding the difficult and costly tax controversy process.

First, this type of simplification requires a commitment to getting things right as they come in the door. In some ways I think of this as building a quality system

or quality product as we have done with the American automotive industry. In the 1970s our automotive industry did not focus on quality in the product it built and it lost significant market share to the Japanese who, using quality principles developed in America, did build quality cars. Over time American car manufacturers adopted quality techniques and now produce high quality products. We need the same high quality product to be produced in the tax return process and the same quality control at the IRS in initially reviewing and verifying the return in order to simplify or tax system to one that focuses on getting it right at the outset rather than pushing people into a tax controversy process most low and middle income taxpayers have significant difficulty in navigating.

Second, while simplifying the substantive tax provisions taxpayers must address in preparing returns would certainly help, we need to acknowledge that proper assistance with the return is a key to preparing a correct return. Return preparers should have basic competencies before being allowed to charge for their services and tax preparation software should have design functions that lead taxpayers to the proper result. Focusing on the individuals and programs that lead to a correct return should greatly simplify the system and the taxpayer experience in dealing with that system.

Third, the IRS should go into the filing season armed with the data necessary to verify the correctness of returns prior to issuing refunds rather than using available third party verification data to test correctness after issuing refunds. The simple process of verification with available data prior to issuing refunds should prevent significant complexity in fixing the problem through the tax controversy system. This is a relatively easy fix to reduce complexity from a technological perspective but will require some retooling of our psychological expectations with regard to the timing of the filing season and the issuance of tax refunds.

Question. Will modifications reduce complexity?

Answer. Yes. I believe that the modification in the tax return preparation process and filing process with reduce complexity for the reasons discussed above. Even though we generally think of tax simplification as modifying substantive tax code sections to reduce the number of tests required to claim a particular benefit, I believe that simplifying the process is also a form of tax simplification and perhaps a more important form. In 1986 the reduction of the rate structure was touted as major simplification. While laudable, this type of simplification makes little difference given available software programs. The big difference maker for low income taxpayers is keeping them from getting caught up in a system where they must attempt to interact with the IRS after the return process. These subsequent interactions generally cost too much for them to afford representation and present too many procedural, language and cultural barriers for them to succeed. The subsequent interactions also put a strain on the IRS which is trying to obtain information from a group that generally does a poor job at responding. This often leads to assessment of additional tax and 10 years of the collection process costing both the IRS and the taxpayer years of "complexity" in the relationship trying to fix a problem that should not have occurred in the first place. Once in the collection system, the IRS is offsetting future refunds, sending additional notices, filing notice of lien and complicating taxpayer's lives in many ways that may not be apparent to someone focused solely on simplifying the substantive code provisions.

Question. In Ms. Markman's written testimony, she says that one area of tax law that is ripe for simplification is the rule requiring taxpayers that have reached age 70½ to take annual required minimum distributions (RMD) from all of their retirement accounts. If I understand that point, a retiree with both a 401(k) account and an IRA, a very common situation, must withdraw their annual RMD for the 401(k) only from the 401(k) account, and the RMD for the IRA only from the IRA. Ms. Markman suggests that we should allow a retiree to withdraw the full RMD from either the 401(k) account or the IRA, as this would be useful for retirees and would not result in any loss of tax revenue. In light of the aging of the baby boom generation and the consequent increase in retirement plan distributions system-wide, could you elaborate on the complexity of the RMD rules and how this Committee might help retirees by simplifying the rules, which I understand are quite complex and which a retiree must grapple with every year?

Answer. I am not an expert in this area. My limited knowledge of this issue comes from assisting elderly relatives in return preparation. From that very limited perspective, I am uncertain that having the RMD issued by one source would simplify the process because doing so would require the individual to properly communicate with the primary source about all of the other retirement accounts in order to en-

able the primary source to properly calculate the RMD. It would also require the secondary sources to know that they need not make the RMD. Perhaps this level of communication is easier to achieve than I anticipate. Assuming it is easy to get the various sources of distribution to talk to each other, I agree that it is easier for the recipient to receive the distribution from one source. My concern based on my family members is that they have multiple sources of distribution of relative small amounts and communication among these sources may not always work smoothly.

Question. In Ms. Markman's written testimony, she comments on some of the complexities associated with the various pass-through forms of business entities, in particular partnerships and S corporations. Ms. Markman specifically mentions that "[i]n the interest of simplicity and fairness, there should be one type of flow-through entity where the owners enjoy the same benefits." Would you elaborate on your opinions of this idea? More specifically, what would be some of the important features of such a regime? In addition, what transition issues should we be concerned with in a move from the current rules to this new regime?

Answer. I am not an expert in this area and do not feel sufficiently comfortable with the subject matter to be able to provide you with meaningful input.

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

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R–Utah) today delivered the following opening statement at a committee hearing on simplifying the tax code:

The committee will come to order.

I want to welcome everyone to today's hearing to discuss simplification of the tax code. I also want to thank our witnesses for appearing before the committee today and for the written testimony they have submitted.

This is the third hearing the committee has held to explore the principles of tax reform embraced by President Reagan nearly three decades ago. Those principles were efficiency, fairness, and simplicity. We have held hearings on the importance of growth and efficiency, and of fairness, in tax reform. Today, we will discuss the problem of complexity in the tax code and the merits of simplification.

There are many sources of complexity in our tax system, including a lack of clarity and readability, the use of the federal tax system to advance social and economic policies, increased complexity in the economy, and the interaction of federal tax laws with state laws, other federal laws and standards, the laws of foreign countries and tax treaties. The proliferation of credits, deductions, exclusions, exemptions, fees, and excise taxes, all of which were presumably intended by their proponents for good, also add to the overall complexity of our tax system.

Over the years our tax code has grown to almost 4 million words. Today, approximately 59 percent of American households use paid preparers to do their individual income taxes and another 30 percent use tax software to assist them. Taxpayers and businesses spend over 6 billion hours a year complying with tax-filing requirements with compliance costs totaling over $168 billion annually.

That is larger than the entire economy of New Zealand.

That amount would employ more than 3 million workers full time at a wage of $25 an hour.

Wouldn't that money be better off in the hands of hardworking taxpayers, instead of devoted to complying with our overly complicated tax code?

Imagine: A simpler tax code that greatly reduces compliance costs, resulting in a tax code that is efficient, effective, and accountable to taxpayers. In other words, a tax code that Americans can actually understand.

As was noted in the comprehensive report on tax reform the Republican staff of the Finance Committee released in December, simplification often gets overlooked or relegated to secondary status in the tax reform discussion. That should not happen. Complex tax provisions—such as the personal exemption phase-out, or PEP, the overall limitation on itemized deduction, or Pease, or the AMT—effectively force taxpayers to seek costly help from professional preparers.

Complexity should be a matter of concern for tax policymakers because it makes it more difficult, time-consuming, and expensive for taxpayers to comply with the law and for the IRS to enforce it. Complexity also reduces perceptions of fairness in the tax system and can decrease voluntary compliance with the tax laws.

But, of course, simplification is not without its trade-offs. For example, there is often a tension between fairness and simplicity. Simple statutes may not be fair because they lump together taxpayers who, in fairness, should be treated differently. And statutes that comprehensively address relevant distinctions between taxpayers, leading to fairness, tend to be more complex.

But, no one said tax reform would be easy. These tensions and tradeoffs come with the territory and should not deter our efforts.

Today we will hear from four witnesses on the front lines of the tax reform debate and we look forward to discussing with them the pros and cons of simplification of the tax code.

I will now turn to Ranking Member Wyden for his opening remarks.

PREPARED STATEMENT OF CAROL MARKMAN, CERTIFIED PUBLIC ACCOUNTANT AND DIRECTOR OF TAXATION, EP CAINE AND ASSOCIATES CPA, LLC

I am Carol Markman, a CPA from Westbury, NY. I am Director of Taxation for EP Caine & Associates, CPA LLC of Bryn Mawr, PA. For over 35 years, I have worked with individuals and small businesses specializing in taxation.

I currently serve on the Tax Executive Committee of the American Institute of Certified Public Accountants and previously served a 3-year term as a member of the Internal Revenue Service Advisory Council (IRSAC). I am a Past National President of the National Conference of CPA Practitioners, NCCPAP, the only professional organization focused on representing Certified Public Accountants in Public Practice, and a past chairperson of its Tax Policy Committee. Accompanying me is Stephen Mankowski, CPA, a partner of EP Caine & Associates , CPA LLC of Bryn Mawr, PA and the National Executive Vice President of NCCPAP and the current Chair of the NCCPAP Tax Policy Committee.

Thank you for your invitation to speak at this hearing on the merits of simplification in tax reform. Simplicity is a lofty goal in tax reform that many of us would like to see, however, simplicity frequently leads to unfair and/or unreasonable outcomes. For example, the simplest type of tax is a sales tax but it is the most regressive type of tax since it places the highest proportionate burden on those least able to pay the tax.

I have chosen to speak about several areas which I believe cry out for simplification paired with fairness and equity:

- Retirement plans
- Education incentives
- Definitions in the tax code, in particular modified adjusted gross income
- Allowable mileage rates
- Different forms of business entities

RETIREMENT PLANS

There are many different types of retirement plans; 15 are listed on the IRS website. Many taxpayer have more than one type of plan when they reach age 70½. This age is important because at 70½ taxpayers must begin taking an annual required minimum distribution (RMD) from all of their retirement plans except if they are currently employed by the organization that is the sponsor of the plan or their account is a Roth Individual Retirement Account (Roth IRA). The amount that must be withdrawn is based on the account balance at the end of the immediately preceding calendar year, the plan owner's age during the current year and a factor from one of two IRS approved tables depending on the age of the beneficiary.

One area of tax law that is ripe for simplification is the rule requiring a taxpayer to withdraw an RMD from each type of retirement account. Once the Individual Retirement Account (IRA) owner calculates the RMD for each IRA that he or she owns, the IRA owner can withdraw the total amount from one or more of the IRAs. Similarly, a 403(b) contract owner must separately calculate the RMD for each 403(b)

contract that he or she owns, but can take the total amount from one or more of the 403(b) contracts.

However, RMDs from other types of retirement plans, such as 401(k) and 457(b) plans, have to be taken separately from each of those types of plan accounts.

This begs the question: Why is it necessary to take an RMD from each type of retirement account? A taxpayer may have a small 457(b) and a large IRA. Perhaps they would like to take the RMD from the entire balance of the small 457(b) and the balance, if any, from the IRA account. Why not permit this? This change creates simplification with no reduction in tax revenue.

Another issue regarding retirement plans is the ten percent penalty for early withdrawal from a plan. There are 12 different exceptions to the additional tax on distributions before age 59½. However, different exceptions apply to different types of retirement accounts. For example, the exception to the imposition of the penalty for qualified retirement distributions made to an alternate payee under a qualified domestic relations order (an order by a judge made to divide a retirement account in connection with a divorce) does not apply to IRAs. Another exception to the penalty is for an IRA distribution made for qualified higher education expenses. This provision does not apply to other types of retirement plans.

It is my recommendation that the penalty exceptions to the additional tax on early distributions from retirement plans be uniform across all types of plans.

EDUCATION INCENTIVES

There are many incentives in the tax law to encourage post secondary education; some are to encourage taxpayers to save for advanced education, some incentives apply while the student is attending school and there is another for the interest on student loans. Many of the incentives have different income phase outs, different limits on the number of years the benefit is available, the number of courses the student must take, what type of expenses qualify for the incentive among others.

Many of the benefits are per family rather than per student. If a family has more than one child in college at the same time, some colleges actually provide additional aid to the family. However this aid it is not necessarily sufficient enough to offset the combined costs of tuition and other higher education related costs for multiple children in college at the same time. These per-family limits on benefits are very unfair and place additional stress on the family budget.

Some of the benefits are available for a specific number of years but some college programs such as a Bachelor's degree in accounting are required by some states to be 5 year programs. Also some students are not able to carry enough credits so that they can graduate in the expected number of years because they must work while going to college.

The phase-out of the benefits for high-income taxpayers should be made uniform across all similar incentives and there should be a separate phase-out for taxpayers filing as Head of Household (HOH). Currently the phase-out for taxpayers filing as HOH is the same as for single taxpayers but their family financial circumstances are frequently very different. Many taxpayers filing as HOH are raising their children on their own with little or no other support.

There is a need to coordinate the various education incentives so that the benefits are available to the desired taxpayers with less confusion. Fewer tax provisions with uniform phase-outs, per-family limits, and types of allowable expenses would go a long way to simplifying these provisions. A computer should not be needed to determine which education benefits apply and which ones provide the best tax result for a taxpayer.

MODIFIED ADJUSTED GROSS INCOME

There are many definitions of Modified Adjusted Gross Income (MAGI) that factor into the preparation of individual income tax returns. MAGI are determined by adding back certain items to the individual's Adjusted Gross Income (AGI).

The difficulty is determining which items of income or deductions are added back. This varies with the provision in the tax code for which MAGI is being calculated. Items such as foreign earned income, foreign-housing allowances, student-loan deductions, IRA contribution deductions, passive losses, adoption expenses, and deductions for higher-education costs are add-backs for some tax provisions but not oth-

ers. I have identified 17 add-backs and items not taken into account and two subtractions that are needed for one or more MAGI calculations. I have prepared a chart of some of the more common addback and subtractions, which is attached to this testimony.

The calculation of MAGI is a factor in various calculations including, but not limited to, determining education benefits, who is allowed to make certain types of IRA contributions, the special allowance for real estate professionals, whether a taxpayer has to pay higher Medicare Part B and Part D premiums, the Affordable Care Act Premium Tax Credit and the Health Coverage Exemptions, among others.

MAGI is also used to determine how much of a taxpayer's Social Security Benefits are taxable, and whether a taxpayer is eligible for the adoption tax credit, the retirement savings credit, and/or education tax deductions or credits.

The IRS has a relatively simple MAGI calculator on irs.gov, but this calculator can only be used to calculate MAGI for Passive Activity Loss computations with knowledge that it is for this purpose and no other.

These varying definitions greatly add to the complexity of tax return preparation so that it requires a computer to calculate MAGI in many instances. It would aid in simplification if MAGI for similar provisions could be made uniform. For example, why are non-taxable Social Security benefits an item that must be considered for MAGI in order to make a Roth IRA contribution but not for a Traditional IRA contribution when neither type of IRA contribution is tax deductible?

ALLOWABLE MILEAGE RATES

There are several allowable mileage rates available to taxpayers for claiming deductions in connection with different types of travel: business mileage, mileage to obtain medical care, mileage when moving for a change in employment, and mileage while performing charitable activities. All except the charity rate are annually set by the IRS. The charity rate was set by the Congress prior to 1984 and has not been changed since that time. Other Federal agencies, such as the General Services Administration (GSA), also set mileage rates.

A comparison of the 2015 IRS rates for tax deductions purposes and the GSA reimbursement rates is interesting:

	IRS	GSA Reimbursement
Business mileage—personal auto	0.575	0.575
Business mileage—government auto	N/A	0.23
Medical care and moving mileage	0.23	N/A
Charity activity mileage	0.14	N/A

It does not make economic sense that the rate for charitable activities has not increased in 30 years. Today, that rate is significantly lower than the rate for moving and medical care. Taxpayers view this difference as unfair since many more people can claim mileage for charity than can claim mileage for medical care.

DIFFERENT FORMS OF BUSINESS ENTITIES

The various forms of business ownership, which include partnerships, limited liability companies (LLC), limited liability partnerships (LLP) and corporations, are governed by state laws, rules and regulations. The principal forms of business operations for tax purposes are sole proprietorships, partnerships, S corporations and C corporations. LLCs and LLPs can elect to be taxed as a partnership, S corporation or a C corporation. LLCs are a hybrid type of business that combines features of a corporation with the operational flexibility available to partnerships. LLCs did not come into existence until 1977.

Sole proprietorships, partnerships, S corporations and C corporations are all taxed differently. Sole proprietorships can have only one owner (unless the second owner is the owner's spouse) and are the simplest form of flow-though entity. The net income from a sole proprietorship is taxed at individual rates and subject to self-employment tax. Retirement plan contributions for a sole proprietor are not deductible in the calculation of the owner's self-employment tax.

Partnerships and S corporations are also flow-through entities where the net income is taxed to the partners or the shareholders, whether or not there are funds available to make distributions of the profits.

Partners are not permitted to receive their compensation as wages. Partnership compensation is in the form of guaranteed payments or distributions from the partnership and all partnership income is taxable at individual rates and subject to self-employment tax. Retirement plan contributions for the partners are not deductible in determining self-employment tax.

S corporation shareholders can receive compensation from the corporation in the form of wages. Retirement plan contributions for the shareholders are deductible by the corporation and reduce the FICA tax on the shareholder's wages.

Another challenge is that many businesses that began as corporations want to convert to LLCs but cannot do so because of the adverse tax consequences as a result of such a conversion. Flow-through entities account for nearly 95 percent of all business entities in 2008 according to a 2011 report issued by Ernst & Young.

In the interest of simplicity and fairness, there should be one type of flow-through entity where the owners enjoy the same benefits.

One area that can be simplified—at no cost—concerns the rules regarding the deduction for self-employed health insurance by S corporation shareholders with more than two percent ownership. Currently the S corporation is required include the health insurance premiums in wages. The premiums paid by the corporation are reported on the taxpayer's K–1 from the S Corporation. The taxpayer can deduct the health insurance premiums as an adjustment to arrive at Adjusted Gross Income. The net affect is that more wages are reported on the W–2 but the taxpayer gets a full deduction for the health care premiums, with no change in taxable income.

The simplified procedure would be for the S corporation to pay and deduct the health care premiums and no deduction on the shareholder's individual income tax return. There would be no impact on the taxable income of the taxpayer and no change in the shareholder's taxes.

Thank you for the opportunity to present this testimony.

Respectfully submitted,

Carol Markman, CPA

Definitions of Modified Adjusted Gross Income

	Medicare Premiums Increased for High income	Traditional IRA	Roth IRA	Education credits American Opportunity Coverdale IRA Lifetime Learning	Student loan interest	Tuition & Fees deduction	Education savings Bonds	Form 8582 Passive activities	Form 8962 Premium tax credit	Form 8965 ACA penalty
Addbacks to Adjusted Gross Income:										
Deduction for IRA contribution		X	X					X		
Deduction pension plan contribution								X		
Deduction for deductible part of self-employment tax								X		
Passive income or losses								X		
Real estate losses allowed to professionals								X		
Exclusion for income from U.S. savings bonds used for education		X	X				X	X		
Exclusion for adoption expenses								X		
Student loan interest deduction		X	X		X		X	X		
Overall losses from PTP								X		
Taxable Social Security								X		
Tuition and fees deduction		X	X		X	X	X	X		
Domestic production activities deduction		X	X		X	X	X			
Excludible employer-provided adoption benefits		X	X				X			
Non taxable Social security benefits			X						X	

Definitions of Modified Adjusted Gross Income—Continued

	Medicare Premiums Increased for High income	Traditional IRA	Roth IRA	Education credits American Opportunity Coverdale IRA Lifetime Learning	Student loan interest	Tuition & Fees deduction	Education savings Bonds	Form 8582 Passive activities	Form 8962 Premium tax credit	Form 8965 ACA penalty
Tax exempt interest	X								X	X
Exclusion for foreign earned income & housing allowances		X	X	X	X	X	X		X	X
Income from Puerto Rico & American Samoa				X	X	X	X			
Subtractions from Adjusted Gross Income:										
Income resulting from the conversion of an IRA (other than a Roth IRA) to a Roth IRA			X							
Rollover from a qualified retirement plan to a Roth IRA			X							

Prepared by Carol Markman, CPA for the Senate Finance Committee hearing on "Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform"—March 10, 2015.

QUESTIONS SUBMITTED FOR THE RECORD TO CAROL MARKMAN

QUESTIONS SUBMITTED BY HON. ORRIN G. HATCH

Question. Ms. Markman, in your written testimony you say that one area of tax law that is ripe for simplification is the rule requiring taxpayers that have reached age 70½ to take annual required minimum distributions (RMD) from all of their retirement accounts. If I understand your point, a retiree with both a 401(k) account and an IRA, a very common situation, must withdraw their annual RMD for the 401(k) only from the 401(k) account, and the RMD for the IRA only from the IRA. You suggest that we should allow a retiree to withdraw the full RMD from either the 401(k) account or the IRA, as this would be useful for retirees and would not result in any loss of tax revenue. In light of the aging of the baby boom generation and the consequent increase in retirement plan distributions system-wide, could you elaborate on the complexity of the RMD rules and how this Committee might help retirees by simplifying the rules, which I understand are quite complex and which a retiree must grapple with every year?

Answer. Under current law a taxpayer must begin to withdraw a Required Minimum Distributions from all retirement plans by the April 1st of the year following the year they become 70½ except of the taxpayer is still working for the company sponsoring the retirement plan and the taxpayer is not a five percent owner of the business.

The first complication is the age of 70½. It would be much better if the age was 71 or it would be even better if the age was 75 as people are living longer.

The second is the subsequent year April 1st deadline for the first required distribution. Taxpayers do not always realize that if they delay their first distribution to the April 1st of the year following the year they become 70½, they could be required to take two required minimum distributions in that year. This could have an impact on the taxable amount of their Social Security benefits, the amount of their allowable deduction for medical expenses and other deductions. I suggest that the first distribution be required in the year in which a taxpayer turns 71, period.

A third complication is the charts that the IRS has developed. The Uniform Lifetime chart must be used by most retirement plan owners. However, there is an alternative chart that is to be used if the beneficiary is a spouse who is more than 10 years younger and the sole beneficiary of the retirement plan owner. There is a third chart that must be used by beneficiaries of retirement plans and there are different rules entirely if there is no designated beneficiary. Perhaps there some way to simply the charts or at least require the IRS to develop an online calculator. To date there are various online calculators developed by brokerages, banks and other organizations but none are authoritative.

Another issue is that the IRA beneficiary distribution rules are different based on whether the retirement plan owner died before or after the required beginning date. One set of rules would be helpful.

Question. Ms. Markman, in your written testimony you noted that ". . . many businesses that began as corporations want to convert to LLCs but cannot do so because of the adverse tax consequences as a result of such a conversion." Is the effect of double taxation the driving force behind the desire to convert? What are the other drivers of the desire to move from corporate to pass-through status, and how does simplification from the perspective of the business owners and managers factor into that decision? Also, please highlight for us some of the important tax and non-tax considerations that you see in practice with your business clients that make such a change difficult?

Answer. No, I do not think double taxation is the issue as the owners of the corporations that have lamented that they cannot convert to LLC are corporations that have elected to be taxed as S corporations. I think the desire to convert to LLC status is to allow the business to be taxed as a partnership. Before LLC were permitted under state laws, partners in partnerships had unlimited liability. Partnerships offer a lot more flexibility than S corporations.

Once a business is organized as a corporation, conversion to a partnership carries significant tax consequences, specifically the tax on built in gains of assets that have appreciated.

Some of the reasons why businesses may want to convert:

- LLC statutes in terms of administration are much simpler and more forgiving. Corporations require annual meetings, board meetings, etc. LLC does not require any of that as a Member ran LLC can simply designate authority to a Manager.
- Many businesses formed prior to LLC in 1990 have been stuck. They could not convert to be S corporations prior because their ownership was not agreeable to making an election to be taxed as an S corporation or they were not eligible to be taxed as an S corporation (35 shareholders back then but mainly just ineligible shareholders owning the stock such as corporations which are not allowed to own stock in S corporations and non-resident aliens). Even though they wanted to have the advantage of a single level of tax but they could not do so because of ownership issues.
- Conversion to a partnership from C corporation gives current owners more flexibility in allocating profits to more closely recognize economic business relationships.
- Conversion to a partnership from C corporation would allow existing businesses to more easily facilitate mergers with appreciated property (any contributions of appreciated property to a C corporation that fail the control test will also be taxable whereas under subchapter K this will not be the case).
- Even if a business is going to convert and be responsible for the tax, most would have to value the assets of the C corporation business to correctly assess tax.

Question. Ms. Markman, in your written testimony you comment on some of the complexities associated with the various pass-through forms of business entities, in particular partnerships and S corporations. You commented that "[i]n the interest of simplicity and fairness, there should be one type of flow-through entity where the owners enjoy the same benefits." Would you shed a bit more light on this idea for us? More specifically, what would be some of the important features of such a regime? In addition, what transition issues should we be concerned with in a move from the current rules to this new regime?

Answer. Many people who form business entities believe that there is status in not operating as a sole proprietorship. In New York it is less expensive to form a corporation than an LLC because of the advertising requirement. So people choose to form corporations and then elect S status, thus achieving pass-through status. This works for many businesses but operational mistakes are made. For example, I have seen situations where a business is formed as an LLC and then pays wages to the LLC members, which is not permitted. Another example is when a shareholder in an S corporation needs to receive a distribution from the corporation to pay taxes on the S corporation income and the other shareholder has their own resources to pay the taxes. This is currently not permitted.

Any new type of business entity should provide the most flexibility in order to aid business and economic activities. Some issues to consider are:

- No limit on the number of owners.
- Owners can receive income as salary subject to withholding taxes if desired and they provide services to the business.
- Allow check the box election for tax status so that the business could elect to be taxed as a corporation or to be a disregarded entity if it has only one owner.
- Will fringe benefits including health insurance and Social Security taxes for owners be deductible by the business entity?
- Will all net income be subject to self-employment tax?
- Will net income be subject to the net investment income tax?

This would require cooperation by the states to recognize this new type of entity and its flow-through status.

Some transition issues are:

- How will S and C Corporations be taxed on non-liquidating distributions?
- How would debt recapture for partnerships primarily that are being funded on debt basis be handled? This could cause phantom gain recognition if the business entity would be converted to an S corporation like regime.

- Would S corporations still subject to the built in gains tax after conversion from a C corporation?
- How would partnerships that currently have capital account percentages different from profit/loss percentage be handled?
- How will tiered flow-through entities be handled? Right now there can be multiple tiered entities, which sometimes makes tracing the income to the ultimate taxable individual very difficult. Also, not all states permit tiered flow-through entities.

PREPARED STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON

If we opened up the hearing room curtains and looked outside, we'd see that the gloom of winter has finally lifted. But instead of enjoying the beginning of spring, millions of Americans are stuck buried under mountains of tax forms, documents, and receipts. Around this time of year, I start to hear from Oregonians that they're sick and tired of this painful process of filing taxes. I am right there with them.

Our tax system has become so incredibly complicated, even somebody who really knows her way around an accounting textbook has a hard time getting everything right.

The fact is, our overcomplicated tax code divides taxpayers into very different worlds. There are the lucky few who can afford to hire tax pros to game the system with "wash sales," "options collars," and "swap contracts"—activity detailed in a report I released last week. Then there's everybody else just trying to put their tax return in the rear-view mirror.

It's a whole lot harder to use the code to your advantage if you're a middle-class individual, a small business owner, or a family just getting by. For example, when a family needs help paying for higher education, there are more than a dozen separate tax incentives to wade through. As if that wasn't complicated enough, each provision has its own set of rules and definitions. The term "small business" is defined more than 40 different ways in the tax code. There are even at least four definitions of a "dependent," which is what most of us know as a "child." And too often, simple errors on these and other tax breaks aimed at the middle-class or low-income families are labeled as fraud.

So to avoid the hours and hours of paperwork, a lot of taxpayers look elsewhere for help. Many turn to software online, but they often end up spending a big chunk of their refund just to file. And as we learned this year, there's always a security risk filing with software. So a lot of other taxpayers look to return preparers. But again, that can be a big financial hit. Even worse, it exposes people to incompetence and abuse by unscrupulous return preparers who don't have the customer's best interest at heart. That's why Senator Cardin and I introduced the Taxpayer Protection and Preparer Proficiency Act this year—to protect taxpayers by setting minimum requirements of competence for preparers.

In the end, comprehensive tax reform is the best way to simplify our tax system across the board. Some people say that it's impossible for tax reform to make the tax code simpler and fairer to everybody at the same time. But I don't buy it. Simplification and fairness are cornerstones of any serious tax reform plan. That's why they're at the heart of the bipartisan plans I developed with Senators Gregg and Coats. Under those plans—which protected low-income and middle-class families—most people would file their taxes on a single, one-page form. When Money Magazine tried it out, it took a matter of minutes to complete a typical return, not hours.

Comprehensive reform won't iron every wrinkle out of the tax code, nor should it. But the experience taxpayers go through every spring doesn't need to be such a nightmare. So let's look at tax reform as an opportunity to get people out from under all the paperwork and give springtime back to taxpayers. I'm looking forward to discussing how to do that with our witnesses today.

COMMUNICATIONS

LETTER SUBMITTED FOR THE RECORD BY DIXIE HICKMAN COLE

Gymea Bay, N.S.W. 2227
Australia
2 March 2015

Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD–219
Dirksen Senate Office Bldg.
Washington, DC 20510–6200
Fax: 0011–1–202–228–0554

To Whom It May Concern:

I was born in the U.S. and came to Australia after University on a teacher's contract. I met my husband and decided to immigrate. I have had my full teaching career here, as well as my family of 2 daughters and now they have married and I have 2 grand-sons. I decided after the same number of 22 years living in Australia as I had the U.S., to become an Australian citizen. My life is fully here now. Both my parents are deceased and I only have two much older sisters in the U.S.

I have worked very hard in my career while in Australia, teaching Students with Special Needs, becoming an Assistant Principal and even receiving an Order of Australia medal, for my work with such students. During that time I thought that I had planned my Superannuation to make sure I would be financial in retirement, not asking of the government in a pension, and trying to cover for possible needed nursing home care, my funeral, etc, as not to be a burden as well on my children, and not knowing how long I will live, for my Superannuation to last.

I never expected, and certainly never planned on the U.S. government deciding to take 15% of it away, which over the time of the rest of my life, will add up to a lot of money, that I may need for the items mentioned above. Otherwise, I may have been able to make different plans in someway to cover for this, but to have it happen after you have retired, there is no way now to compensate for this.

I feel this may be legal in the perception of the U.S. government, considering the treaty is to not double tax, citizens residing outside the U.S., and since in Australia, as of 60 years old, our Superannuation is not taxed. The U.S. then thinks they have the right to tax us, even in my case though I have not lived in the U.S. for 40 years. I do not feel I owe the U.S. this tax, since I have had no benefits from the U.S. in anyway, in all that time.

I feel this is grossly unjust, unfair and immoral, especially since I have always tried to do the right thing and file a U.S. tax report each year, done by a proper Accountant who deals with U.S. tax, which in itself has cost me quite a lot over the years.

I understand the debt the U.S. is in, but is it so low that it has to hit its U.S. citizen retirees who have for most of their life resided in another country and who are just trying to financially live out their years that are left. I lost my husband to cancer 5 years ago, and through the grieving have suffered physical health problems as well as depression, and anxiety. I did not need the stress and worry of knowing that I was going to lose 15% of my Superannuation as well.

Hoping the U.S. government will review this decision, when understanding the hardship in lots of cases that it is causing.

Dixie Hickman Cole

LETTER SUBMITTED FOR THE RECORD BY MARTHA HENDERSON

Engadine NSW 2233
Australia

The Honorable Senator Hatch, Chairman
The Honorable Senator Wyden, Ranking Member
Senate Committee on Finance
Attn. Editorial and Document Section
Rm. SD–219
Dirksen Senate Office Bldg.
Washington, DC 20510–6200

March 10, 2015

Written Statement for the Senate Finance Committee March 10, 2015

"Tax Complexity, Compliance and Administration: Merits of Simplification in Tax Reform"

Dear Senator Hatch and Senator Wyden,

I appreciate the opportunity to submit a written statement for the record of the Senate Finance Committee Hearing on March 10, 2015 regarding tax complexity, compliance and administration as they relate to tax reform.

The Senate Finance Committee is taking important and much needed action by considering these issues as an integral part of addressing tax reform during the 114th Congress.

Today's economy is global in nature. New ways of doing business, an array of new technologies and a more mobile workforce have resulted in a complex tax system which is difficult to administer and has led to issues around compliance. Both the IRS and the tax payer would welcome measures that simplify the tax system.

I write from the perspective of an American citizen living abroad who:

- Has resided and worked in Australia since 1973;
- Became a dual citizen of the U.S. and Australian in 1995;
- Has met my legal obligations by submitting annual income tax return to both the Internal Revenue Service and the Australian Tax Office; and
- Requires the services of a tax professional to prepare my U.S. income tax returns due to the complexity of reporting.

My comments are from the perspective of a non-resident citizen, they focus on the complexity of the tax system as it relates to individual tax payers and inadequate service provision by the IRS.

Complexity of the Tax System as it Relates to Individual Tax Payers

In recent years preparing and submitting income tax returns has become much more time consuming and expensive for non-resident citizens.

A significant amount of reading and a high level of understanding of the system is required before one can understand which forms need to be submitted, let alone accurately complete them. The number of forms that must be completed, the duplication of information required and the complex nature of instructions can easily result in errors on the part of the individual, thus causing a heavy administrative load for the IRS.

Some of the information required for completing tax returns is difficult if not impossible to obtain. For instance in Australia some retirement fund managers are unable to provide information required for U.S. tax returns because of the way the funds are structured and because fund managers are not required to provide the information for either U.S. or Australian tax reporting purposes.

More and more non-resident citizens require the services of a tax professional to prepare their returns. It can be difficult for non-resident citizens to find a good and affordable tax professional. High costs are also incurred for printing, postage and conversion of funds to U.S. dollars for payment of any tax owing.

Both taxpayers and the IRS would benefit from a simplified tax system that reduces the volume of reporting requirements and eliminates duplication of reporting. They would also benefit from revised forms and instructions that are easier to understand and use consistent terminology.

A residency based taxation system would alleviate many issues currently faced by non-resident citizens.

Inadequate Service Provision by the IRS

When I first came to Australia non-resident citizens were able to seek assistance and technical advice from an IRS officer at the U.S. Consulate. This service assisted many U.S. citizens residing in Australia to understand and comply with reporting requirements. The service was withdrawn some years ago and it is now much more difficult to get assistance of a general nature.

When one receives a notice from the IRS advising of errors in their return they encounter a number of difficulties including:

- The notice arrives close to or after the deadline for action. There is no time to analyze the content of the notice, to seek-advice or to prepare an amended return, and if money is owing people find themselves facing penalties for late payment.
- It is very difficult to obtain clarification from the IRS about errors in a tax return or options for addressing them. Correspondence by post takes weeks. Even if a person immediately writes to the IRS seeking information they receive further correspondence from the IRS advising that they owe interest before their queries have been addressed. It appears that a number of individuals or departments within the IRS are dealing with one individual and that they don't communicate with one another.
- Individuals who endeavor to make contact with the IRS by phone also face difficulty. Different time zones can provide only small windows of opportunity for discussing issues of concern. This is exacerbated by long wait periods once a call has been placed—I was on hold for more than 45 minutes on two occasions when I contacted the IRS regarding my, 2012 return. Information and advice provided over the phone are delivered quickly by people who are very familiar with the tax system and reporting forms. There seems to be little understanding or appreciation that the person on the other end of the phone is not so conversant with the system and needs information to be fully, clearly and more slowly delivered. As with written, correspondence there appears to be a breakdown in communication between the IRS officers who provide information and advice over the phone and those who send delinquent notices—I was advised over the phone that a hold would be put on my case until I had submitted either a payment or an amended return; however I received a delinquent notice telling me that I owed more interest.

The current process of communicating with the IRS to resolve issues makes people feel frustrated, and intimidated. Sometimes they give up altogether and never submit another tax return.

Both the Individual taxpayer and the IRS would benefit if the IRS were funded to implement a more customer focused service, including the following:

- An IRS case manager assigned to assist an individual to effectively and efficiently resolve an issue;
- Email and video conference communication options to facilitate issue resolution and efficiency of service;
- IRS officers who were trained in how to communicate clearly with their clients using both verbal and written communications;
- Longer time frames for postal communication with non-resident citizens in recognition of the time it takes for international postal movements; and
- A more integrated internal IRS system of communications that reduced the incidence of IRS officers working at cross purposes.

I look forward to the 114th Congress enacting a simplified taxation system as well as working with and funding the IRS to develop customer support mechanisms, including documentation and communication systems that support taxpayers and facilitate compliance.

Regards,

Martha Henderson

STATEMENT OF CALVIN H. JOHNSON, UNIVERSITY OF TEXAS LAW SCHOOL

When "Simplification" is a Trojan Horse for Great Harm

Statement for Hearing of United States Senate Committee on Finance March 10, 2015 on Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform

Congress's tax code is frequently way over the top too complicated. With hard work, and perhaps a bit of genius, Congress can simplify the law in a number of areas, even while improving the fairness and efficiency of tax.

But Watch Out and Beware! Many proposals offered to this committee under the cover of simplifications are terrible ideas that will increase the harm that tax will do to the sum of human happiness. Indeed, in this hearing, the committee is being offered ideas that will shift tax burden away from those best able to bear tax downward onto poorer taxpayers!

The Committee needs to ensure that any idea seriously considered as a simplification either shifts the burden of taxation upward to taxpayers better able to pay tax or, at least does no more harm.

A. Moral Decision Makers Do Not Shift Tax Burden Downward.

Dollars have different values depending upon who gets them. Uncle Scrooge McDuck uses his dollars in lieu of water in his swimming-pool vaults. When he spends beyond the vaults, he buys caviar, truffles and bon bons. The loss of any one dollar does not hurt his utility much. For the Little Match Girl, by contrast, a dollar is a matter of life and death. Take her last dollar and she freezes to death. The richest man in the world has the same worth in the sight of God as the Little Match Girl; it is just the richest man has to spread that worth over $80 billion and the Little Match Girl spreads her worth over one dollar. Spreading worth over $80 billion does not quite reach an infinitesimal value for each dollar, but one over 80 billion per dollar comes close.

We all display the diminishing utility of money by buying insurance, by aversion to risk, and by saving as a cushion for a rainy day and for retirement. The prime directive of personal finance is to spread out consumption of life-time income over your full life because doing so maximizes value of each dollar, given diminishing utility.[1] If your income comes in like a roller coaster ride, you need to move dollars from the high-income years at the top to the years in the trough. Otherwise, in the trough, you have no money for to pay the rent, and you will be trying to eat sand. A tax on money in the trough or a shift of the tax burden from Uncle Scrooge to the Little Match Girl will increase the harm that tax does to real people.

Counting dollars without accounting for the diminishing utility of a dollar in the hands of wealthier taxpayers would imply that if there was a program that stole all dollars from the population of 250 million and gave it to one person, but added one new dollar in the process, then the program would be treated as good, even though the 250 million losers would starve to death. GDP measures dollars without diminishing utility, which makes it a questionable measure.

This country is also becoming more unequal, as measured by a confluence of alternative data. There is a wonderful animation of how wealth has shifted from poor to rich since 1963, prepared by the Urban Institute using Survey of Consumer Finance data. The moving pictures are a must see, worth a thousand words, for each frame.[2] According to World Top Income Data Base, the top 1 percent of richest U.S. taxpayer received 9 percent of U.S. total income in 1973, including capital gains, and now the top 1 percent receives 23 percent of such income, which means over two and one half times greater concentration of wealth in the top 1 percent over the last 30 years.[3] The richest taxpayer do now pay a larger fraction of total taxes than they did 40 years ago, because they are in higher tax brackets and better able to pay tax, but they do not pay 2½ times their previous share of taxes.[4] Indeed,

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[1] *See, e.g.,* Franco Modigliani, "The Life-Cycle Hypothesis of Saving Twenty Years Later," in *Contemporary Issues in Economics* 2 (1975).

[2] *http://datatools.urban.org/Features/wealth-inequality-charts/img/WealthPercentiles.gif.*

[3] *http://topincomes.parisschoolofeconomics.eu/#Graphic.*

[4] Republican Staff of the Senate Finance Committee, Comprehensive Tax Reform for 2015 and Beyond, at 61 (December 2014), (hereinafter "Hatch Report"), *http://www.finance.senate.gov/newsroom/ranking/download/?id=41af09bb-e75d-4246-9313-98eb5b9de*

since 1979, according to Congressional Budget Office, the top 1 percent has had a reduction in all taxes as a percent of income, dropping from total tax that is 40 percent of income down to total tax that is 30 percent of income.[5] Even in the short term, inequality is getting worse. From 2010–2013, according to Federal Reserve data, the average income of the top 10% increased by 2 percent, but average income *decreased* by 5 percent.[6]

The United States also does the least in the group of rich European and North American countries to improve the distribution of income.[7] The better performance outside of the United States, however, is primarily attributable to higher social safety-net spending elsewhere, because European taxes are not especially progressive overall.[8]

1. Flat tax.

A flat tax is a tax that imposes the same tax rate on Uncle Scrooge and the Little Match girl. A flat tax is touted as simpler than a bracket tax because one rate would apply to all income, no matter what its utility.[9] A flat tax, however, would increase the damage that taxes do because it would increase the tax paid by the Little Match girl and reduce the tax paid by Uncle Scrooge for any given level of government.

A bracket system has many different tax rates. It is plausible that diminishing marginal utility is a continuous function from near infinite value for the Little Match Girl to near infinitesimal value for Uncle Scrooge. As people rise in economic income they move from destitution, to subsistence, to modest comfort, to middle, to comfortable, to luxurious, and finally to splendiferous bon-bons. To do the least damage, a perfect bracket system would adjust marginal rates to the diminishing marginal utility of each layer of available dollars. Fewer brackets make it harder for the rates to adjust to utility.

There is no evidence that a system with fewer brackets is more efficient.[10] The brackets are built into tax tables or Turbo Tax. Indeed, fewer brackets can cause more adverse taxpayer reactions to tax because fewer brackets require bigger jumps in marginal tax rate between the brackets for the same revenue. With bigger jumps in rates, it is plausible that a taxpayer will notice the rate bump more often and will have a greater motivation to alter behavior to avoid a big jump to a significantly higher bracket. It is the taxpayer reaction to tax that causes deadweight loss, without giving revenue to the Treasury.

Simplification is being used in the flat tax argument as a Trojan Horse to reduce the tax rate on Uncle Scrooge. High marginal taxes at some point do diminish economic activity so much that they reduce the Treasury's tax yield—that is the famous Laffer curve. If tax rates are higher than the rate yielding peak revenue, then a reduction in rates would then be "optimal" and would increase the Treasury's yield. Both the government and highest rate taxpayers would be better off. If the tax base is solid and tax is unavoidable, however, the optimal, maximum-revenue rate is quite high—at 73 percent.[11] Congress can keep the revenue-maximizing rate high by reducing Uncle Scrooge's loopholes and ignoring the formal changes without substance that now allow him to avoid tax. Indeed, the increase in tax on those best able to bear tax needs to be accomplished entirely by making taxable income better describe standard of living, and not by raising tax rates at all. No one wants a 73 percent tax rate, at least in peace time, but the optimal rate calculations indicate that there is considerable cushion before we need to worry about tax on Uncle Scrooge being too high.

7bc at 62–63 (Table 4.3) showing tax share paid by top 1 percent not quite doubling (180%) between 1980 and 2011).

[5] Congressional Budget Office, Trends in the Distribution of Household Income, 1979–2007, at 26, fig. 18, *http://www.cbo.gov/sites/default/files/10-25-HouseholdIncome_0.pdf //www.*

[6] Steven Rattner, The Year in Charts, NY Times December 30, 2014, *http://stevenrattner.com/article/the-year-in-charts/*.

[7] Steven Rattner, The Year in Charts, NY Times December 30, 2014, *http://stevenrattner.com/article/the-year-in-charts/*.

[8] Hatch Report at 62.

[9] *See, e.g.,* J.D. Foster, The New Flat Tax: Easy as One, Two, Three (Dec. 13, 2011) *http://www.heritage.org/research/reports/2011/12/the-new-flat-tax-easy-as-one-two-three.*

[10] David Altig & Charles T. Carlstrom, The Efficiency and Welfare Effects of Tax Reform: Are Fewer Tax Brackets Better than More? (Minneapolis Federal Reserve Board 1992), *https://www.minneapolisfed.org/research/dp/dp78.pdf.*

[11] Peter Diamond and Emmanuel Saez , *The Case for a Progressive Tax: From Basic Research to Policy Recommendations* 24 J. ECON. PERSPECTIVES 165, 171,
https://www.aeaweb.org/articles.php?doi=10.1257/jep.25.4.165.

The reductions in the top tax rate over the last 65 years, moreover, are not significantly correlated with greater economic growth and increases in tax rates are not correlated with less growth.[12] The downward shift in the distribution of tax without added growth has increased the harm of tax. A flat tax, that is, constant tax rates, is a harmful idea, even evil.

2. Expensing.

It is sometimes argued that simplicity requires that small business taxpayers should be allowed to deduct equipment and inventory that they have not lost and exclude sales on credit from taxable income.[13] Those proposals will create an uneven playing field in which bad investments win over better ones solely because of tax. In a neutral income tax, taxable income identifies the interest-like income from a business—the internal rate of return from the investment—and taxes it. Taxable income will identify the internal rate of return only if adjusted basis describes the investment value that the taxpayer still has and has not lost. Deductions in an income tax need to be limited to amounts the taxpayer has lost. Identifying the internal rate of return with taxable income is the only way to prevent an investment price from being higher for high bracket buyers who then outbid low bracket buyers. Identifying the internal rate of return is the only way to prevent tax shelters when investments are debt-financed. Identifying internal rate of return is the only way to prevent inferior investments from winning over better ones, solely because of tax.[14]

For nontax purposes, the accountants have long concluded that accounting can reflect income only if amounts not lost are not deducted. Inventory accounting is well worth the effort even for small business. The effort of putting together books of accounting will not reflect income or any kind of economic reality if amounts not lost are deducted. Simple and stupid accounts are not worth it. Sales on credit are still sales, moreover, and subsidy for selling on credit has no justification. The amounts involved at $1 million are well in excess of trivial amounts that might be ignored in rounding. If businesses are going to bother to keep track of costs in order to deduct them, they should account for them right.

Allowing costs that are not in fact lost to be deducted as if they had expired is a subsidy, equivalent to exemption from tax the return from the investment in the expensed items. That exemption subsidy will induce investment in inferior projects that cannot meet the general global cost of capital.

We do not now have a caste system giving an exemption from tax for people called "small business" even when they are appropriately in high tax brackets. It would be inefficient and inequitable to allow such expensing.[15]

3. VAT

It is sometimes said that a value added tax ("VAT") would simplify taxation.[16] A VAT is a kind of sales tax on gross receipts, except that a VAT entails lots of paper work along a chain of production and supply. The extra paper work improves compliance.

VATs necessarily entail complexities. When adopted, the UK VAT had four categories of goods: normal tax, exempt, zero tax and mixed. For zero tax goods, taxpayers further along the production chain got credit even though no tax was paid. The whole system was administered by the Bureau of Customs and Excises which had a tradition of viewing every taxpayer as a smuggler.[17] Even now, the European VATs have large and growing evasion problems they need to deal with.[18]

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[12] Thomas L. Hungerford, "Taxes and the Economy: An Economic Analysis of the Top Tax Rates Since 1945 (Updated)," CRS (Dec. 12, 2012).

[13] Experts #3 and #15, Appendix A, Mihir A. Desai, Testimony before Senate Finance Committee, Hearings on Tax Complexity, Compliance, and Administration: The Merits of Simplification in Tax Reform, (hereinafter "Desai Statement"), *http://www.finance.senate.gov/hearings/hearing/?id=d121784e-5056-a032-52f3-e7560f44c675.*

[14] Johnson, *Measure Tax Expenditures by Internal Rate of Return,* 139 TAX NOTES 273 (April 15, 2013).

[15] Johnson, *What Is Very Wrong in Obama's Business Tax Reform.* 146 TAX NOTES 627 (Feb. 2, 2105).

[16] See, e.g. Joel Slemrod, The Simplification Potential of Alternatives to Income Tax, 66 TAX NOTES 1331 (1995) (touting VAT as simplification but only as replacement for income tax).

[17] William Turnier, *Designing an Efficient Value Added Tax,* 39 TAX L. REV. 435 (1984).

[18] "2012 Update Report to the Study to Quantify and Analyse the VAT Gap in the EU–27 Member States," European Commission (Sept. 2014).

VATs have no way to exempt the Little Match Girl at the cashier counter. It is also not all that simple to find the Little Match Girl by other means to give her a refund of VAT that we really do not want her to pay. Inevitably VATs get complicated as legislators try to avoid freezing little girls. For example, most states exempt from sales tax food for home consumption to help those with lower incomes, but they tax restaurant food, which affects those with higher incomes.[19] Thus, caviar at $2,400 a pound is tax exempt, while a White Castle meal at $2.99 is taxable. In Texas, tax is due on candy but not on cake. Are Rice Crispies with marshmallows a starchy cake or a sweet candy? Popsicles are subject to tax or not depending on whether they are more or less than 50 percent fruit juice. Texas sales taxes also get complicated because of exemption for products covered by other taxes, e.g., natural resources. VATs inevitably become Rube Goldberg machines with very high elasticities across complicated dividing lines, as the tax adjusts to inequity of a simple VAT and to other kinds of taxes. Those lines yields a tax that does a great deal of dead weight damage.[20]

A VAT in this country, moreover, will not replace the income tax, but will be imposed on top of the income tax. That means no reduction in the complexities of the current income tax, nor pressure to improve it, but instead a whole new complicated tax system in addition to current complexities. The issues in the administration of a VAT do not overlap very well with compliance with an income tax, so that an add-on VAT will require a new set of tax specialists for every business. In 1984, the Treasury estimated it would need another 20,000 IRS employees to administer a VAT.[21] That implies that a VAT would also require another block-long limestone building in Washington DC. An add-on VAT is necessarily an increase in complexity.

Since add-on VATs are not justified by simplicity, the surviving "justification" for an add-on VAT is just to shift the burden of tax from Uncle Scrooge to the little Match Girl. We can get a progressive consumption tax, more simply, with a "cash flow consumption tax." A cash flow consumption tax would use the same tax officers, even the same Form 1040. All that would be needed to be changed from current law is a deduction for investment and disallowance of interest deductions.[22] The VAT is offered instead of a cash flow consumption tax because a cash flow consumption tax would not naturally shift tax from Uncle Scrooge to the Little Match Girl, while VAT would. Beware of the VAT and the gifts it brings. Simplification is just a cover.

4. Net Operating Losses.

Some tax experts presented to the committee have called for repeal of limitations on net operating losses ("NOLs") found in section 382 of the Code because they are too complicated.[23] Section 382 largely ended trafficking in NOLs that had also gone on for decades. It is a great success story. A corporation may take NOLs without limitation with a continuation of the same owners in whose hands the losses arose, but if new owners acquire a 50 percent change in ownership within 2 years, the section 382 limitations drop allowable use of NOLs. NOLs may be used after the change in ownership against an amount of income equal to a conservative interest rate times the value of the corporation. If the corporation is worthless, the net operating losses end, but if the corporation has some value, the transferable tax savings from net operating losses would be about 20 percent of the value of the corporation.[24]

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[19] Center on Budget and Policy Priorities, "Which States Tax the Sale of Food for Home Consumption in 2009?" (Nov. 4, 2009).

[20] Johnson, *We Don't Need No Stinkin' VAT,* 139 TAX NOTES 527 (April 29, 2013).

[21] Department of Treasury, 3 Tax Reform for Fairness, Simplicity, and Economic Growth—Value-Added Tax, 111 (1984).

[22] The article that made the cash flow consumption tax a legitimate subject of discussion is William D. Andrews, "A Consumption-Type or Cash Flow Personal Income Tax," 87 HARV. L. REV. 1113 (1974).

[23] Desai Statement, Appendix A, Experts #1, #4, #11, #13, #20.

[24] Net operating losses expire after 20 years. At 5%, a twenty year annuity is worth ⅜ of present value of a perpetuity. Deductions at 35% for 20 years would be worth ⅜ of 35% or about 20%. The calculation depends critically on discount rates, life of the business, future tax rates and other assumptions.

Section 382 was developed by a kind of crowd sourcing over a long period of time.[25] The prestigious American Law Institute and the best tax minds in America at the time contributed to the basic framework. Prior to section 382, corporations could buy their way out of tax by buying net operating losses, sometimes for pennies on the dollar. When corporations best able to pay tax were buying tax losses at too cheap a price, and then tax needed to be increased on taxpayers less able to pay tax. The sale price of naked tax losses, moreover, represented a subsidy or negative tax to businesses that had failed the test of the market place, but had NOLs to sell. It is difficult to see a viable case for subsidy transfer to money losing corporations identified by their having lost money. It is said by way of condemnation that Wall Street believes in privatizing all gains and passing all losses to the government. Unrestricting NOL trafficking was consistent with that mantra, at least up to the level of the tax rate on losses.

If simplification is the only goal, then we might even stop allowing carryover of NOLs in full after a change of ownership. Acquirers sometimes keep a moribund business on life supports just to prevent termination of purchased NOLs.[26] Something other than pure-motive simplification is going on in the proposals for repeal of the section 382 limitations. We can debate limitations on NOLs and look at alternatives, but simplification is not a useful focusing tool. "Simplification" hides conclusions reached for other reasons, and does not illuminate the issues.

5. Straddles and other loss harvesting.

One expert presented to the committee called for repeal of the straddle provisions of section 1092.[27] The underlying problem of straddles is a serious attack on the core of the income tax: In a realized income tax, investors can realize the loss leg of a set of options and hide the gain leg, harvesting tax losses indefinitely without any net economic loss. Beware of special pleading under cover of the name "simplification." We should, of course, adopt rules even more effective against harvesting tax losses. They are endemic in a realized income tax system. But we alas are missing the genius who tell us how to effectively meet and end tax harvesting with a clean, clear administrable rule.

B. Ten Promising Ideas and Areas for Simplification.

The U.S. Navy manuals for operating a destroyer are "designed by geniuses to be applied by idiots."[28] Our tax system needs to be designed by geniuses if it is to be simple. Tax simplification, consistent with fairness and efficiency, is very hard work. Nonetheless there are promising areas that desperately need simplification work, and promising ideas including the following 10 suggestions. None of the suggestions shift the tax burden downward. All but the first will help close the deficit and reduce federal debt. All improve equity and efficiency.

1. Phase out bubbles.

Section 151(d)(3) of Congress's tax code phases out personal exemptions and section 68 of the Code phases out many personal deductions. The impact of the phase outs is identical to an increase in marginal tax rate within a range or "bubble" that disappears for taxpayers with the most income. The bubble is hard to defend on rational grounds because standard of living and ability to bear tax goes up not down as income increases. Congress, moreover, when it is reasonable, understands that more dependents means more mouths to feed and that exemptions for more dependents just make taxable income better reflect standard of living. Within phase outs, however, Congress is punishing larger families, as if more mouths to feed made the household better able to pay tax (!!?). The phase outs take 18 lines of work sheet. The same tax could be collected without the 18 lines, just by adjusting the section 1 top brackets.[29]

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[25] Section 382, as amended by TRA 1986, section 621. *See* George K. Yin, "Of Diamonds & Coal: A Retrospective Examination of the Loss Carryover Provisions," 48 NYU Tax Inst. 41–1 (1990), which gives a description of the development and adoption of section 382.

[26] *See* section 382(c) cutting off carryforwards of NOLs if the old business is discontinued.

[27] Desai Statement, Appendix A, Expert #8.

[28] Herman Wouk, Caine Mutiny, *http://www.goodreads.com/quotes/428350-the-navy-is-a-master-plan-designed-by-geniuses-for,* (applying the argument to all the Navy and not just Navy manuals).

[29] Johnson *Simplification: Replace the Personal Exemptions Phaseout Bubble,* 77 TAX NOTES 1403 (December 22, 1997) (part I),
http://www.utexas.edu/law/faculty/calvinjohnson/77tn1403.htm; Simplification: Replacement of the Section 68 Limitation on Itemized Deductions, 78 TAX NOTES 89 (January 5, 1998) (part II), *http://www.utexas.edu/law/faculty/calvinjohnson/78tn89.htm.*

Given the simple alternative, the function of the phase-out tax, and the apparent historical motive is to hide higher marginal tax rates from the people. Hiding the rates from the people is inconsistent with Congress's moral duty under a democracy of loyalty to the people. Congress itself can be evil.

2. Repeal Qualified Pension plans.

The tax benefits from qualified pension plans are distributed, reverse-Robin Hood, to the richest taxpayers least in trouble in retirement. The benefits become a trickle to the middle class taxpayers who sometimes are in trouble in retirement and sometimes not. And the benefits are denied in full to poorer taxpayers who are in deep trouble in retirement age. If an intelligent mind had designed the benefits as if they were real money, the benefits could not be distributed by this pattern, with the most to given where they do the least good. Indeed, the well-to-do taxpayer who get the benefits generally *reduce* their savings because retirement targets are easier to get, so the rules are even counter-productive as to the top bracket beneficiaries.

The rules for qualification of a retirement fund are complicated even for specialists. They are explained in four Bloomberg portfolios with almost 4,000 total footnotes, and not one footnote is unnecessary to explain Congress's tax code. This is an over-$100-billion-a-year issue.[30] The entire briar patch of qualified plans needs to be repealed.

3. Withholding tax

The face of the law with the most contact with the most people is the withholding of tax, required with respect to employees, but not independent contractors. Congress's Tax Code on this most-common issue for the people is an unforgivable morass. The definition of "employee" depends on "control," which makes sense for tort liability but has nothing to do whether employer or worker should do the paper work and pay over tax before the final reconciliation with the tax return. There is a "safe harbor" that is even more complicated than the employee definition that was adopted in the name of "avoiding complexity." Withholding is avoided by manipulations that should not work. Tax administration implies that employers should handle the payment and paperwork for more than trivial payments because they are better able to handle it. Payments in excess of $2,000 a month should always be subject to withholding. The unworkable "control" test needs to be abandoned.[31]

4. Partnership tax.

Partnership tax rules are supposed to be designed for Mom and Pop partnership but on issue after issue, they are over the top in complexity to accomplish very bad tax policy. Partners get tax deductions shifted to them for losses they do not bear, under regulations that are not comprehensible.[32] We defer recognition of gain or loss upon the bargained exchange by which a partnership is formed, and then load the law down with provisions that take away the deferral upon sale or distribution of the property or swap for other property.[33] The rules are not well enforced. It would be both better theory and simpler to tax the exchanges by which a partnership acquires property. The accountants have it right in treating the initial exchange between arm's length parties as the rock upon which to build an accounting system and that means we should tax the exchange and repeal the complicated deferred tax provisions.

More generally, we need to have partnerships be subject to withholding, audit, settlement, litigation and payment of tax at the partnership level. The IRS does not have the resources to chase down 500 partners, for initial tax, for audit, for settlement, litigation and payment of delinquencies. Even if there are only two partners, having the partnership be responsible for tax by withholding, audit, litigation, settlement and payment would cut the work for all in half. Congress might well consider partnership tax as the final payment, for simplicity, or, in the alternative, it might consider tax paid at the partnership level as a withholding tax and allow individual taxpayers to sue for refund under limited circumstances.

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[30] Johnson, *Amazing Waste: Tax Subsidies To Qualified Retirement Plans,* 144 TAX NOTES 727 (August 11, 2014), *http://ssrn.com/abstract=2485441.*

[31] Johnson, *Settle Withholding by the Dollars, Not Control,* 136 TAX NOTES 949 (Aug. 20, 2012), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2135057.*

[32] Johnson, *Partnership Allocations From Nickel-on-the-Dollar Substance,* 134 TAX NOTES 873 (Feb. 13, 2012), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2005780;* Johnson, *Twice Measured: Partnership Level Debt and Partner Outside Basis,* 135 TAX NOTES—(pending April, 2015).

[33] Johnson, *Recognizing Built-In Gain on Contribution to a Partnership,* 133 TAX NOTES 905 (Nov. 14, 2011), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1961144.*

Partnership tax law is too complicated, indeed, for the IRS to audit given its limited resources. Partnership tax law is one of the most complicated briar patches in the Code, and taxpayers are getting away with results no court would allow, even fraud, because the IRS cannot handle them.

5. Tax Planning Costs.

As a matter of theory the costs of tax planning should not be deducted because the tax reduction achieved by planning is not taxed. The deduction is a subsidy from the baseline of neutral tax accounting. Reducing the subsidy given to tax planning will make the world simpler by reducing tax planning.[34]

6. Internet notice.

The registration of tax liens in the county office where the property is located is way too cumbersome. Notice in the county registration does not inform creditors and IRS gets behind in getting out to the county both to add and releasing liens. In the digital age, an on-line registry would give information to creditors nationally as less cost. Digital registration of tax liens needs to replace county office filing.[35]

7. Capitalization of prepayments.

Current regulations allows you to deduct prepayments that will last no more than one year following close of the year. That is terrible in theory. There is no justification for deducting next year's expenses this year, and no justifying deductions of amounts that have not been lost. Determining whether a payment will expire within the following year also is very hard. Facts about close of the future year are difficult to ascertain because the facts have not occurred. The regulations impose a complicated mechanism to try (inaccurately) to see if a payment will last more than the one year rule based on expectations. Simple theory, simply applied, would capitalize anything called a prepayments. You need only ascertain whether the prepayment had value at the close of the last year.[36] This is a case in which a complicated rule is used to identify if something is so de minimis that it is not worth arguing about, and the complicated rule is six times more complicated than just the correct capitalization rule.

We can avoid some messy valuation disputes in the following three issues.

8. Deduction of excluded appreciation on gift to charity.

We should allow only a deduction of basis on contribution of property to charity. Deducting the appreciation is shelter or double deduction, because the appreciation is both excluded from income and also deducted. Deduction of basis only avoids taxpayer cheating on valuation, and complicated appraisal litigation. Taxpayer can sell at arm's length and give the proceeds, but the tax system and the country as a whole then avoid the appraisal fights over valuation.[37]

9. Retained benefits in Estate and gift tax.

If benefits from property are retained, the measurement date for estate and gift tax needs to be delayed. This is simple straightforward way to avoid multi-billion dollar shenanigans, and hard valuation problems.[38]

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[34] Johnson, *No Deduction for Tax Planning and Controversy Costs,* 129 TAX NOTES 333 (Oct. 18, 2010), *http://ssrn.com/abstract=2070122.*

[35] T. Keith Fogg, *National Tax Lien Registry,* 120 TAX NOTES 783 (Aug. 25, 2008), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1520727.*

[36] Johnson, *Simplification by Repeal of the One-Year Rule for Prepayments,* 124 TAX NOTES 809 (August 24, 2009), *http://www.utexas.edu/law/faculty/calvinjohnson/One-Year-Rule.pdf.*

[37] Johnson, *Ain't Charity: Disallowing Deductions for Kept Resources,* 128 TAX NOTES 545 (Aug. 2, 2010), *http://www.utexas.edu/law/faculty/calvinjohnson/aint_charity.pdf.*

[38] Joseph Dodge, *Retained Interest Transfers under the Estate and Gift Tax,* 133 TAX NOTES 235 (Oct 10, 2011), *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1944327.*

10. Self-imposed valuation discounts. We need to ignore restrictions that the testators put on the property themselves in estate tax valuation. These restrictions probably did not reduce value to heirs in reality, whatever the claim, because testators do not rationally reduce value by putting on a restriction. If the restriction did in fact reduce value to heirs, however, the tax law should discourage waste, as the underlying common law does, by ignoring the destructive restriction.[39]

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[39] Johnson & Joseph M. Dodge, *Passing Estate Tax Values Through the Eye of a Needle,* 132 TAX NOTES 939 (Aug. 29, 2011),
http://www.utexas.edu/law/faculty/calvinjohnson/eye_of_needle.pdf.