

# **SIMPLIFYING THE TAX SYSTEM FOR FAMILIES AND BUSINESSES**

## ***Senate Finance Committee Staff Tax Reform Options for Discussion***

***March 21, 2013***

*This document is the first in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.*

*Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.*

### **CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM**

The Internal Revenue Service (IRS) is charged with the critically important responsibility of administering our tax system. The IRS mission statement reads as follows: "Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all." The IRS is expected to carry out this mission effectively and efficiently, while minimizing the burdens of tax compliance. There are many complex and interrelated components to tax administration that the IRS must manage, including information processing, receipt and disbursement of funds, enforcement activities, and providing taxpayer assistance.

Simplifying our tax laws and reforming the administration of the law is an opportunity to ease the burdens of compliance on taxpayers. It is also an opportunity to allow the IRS to accomplish its mission more fairly, efficiently, and effectively. Following are some potential broad principles for reform in this area:

- Reduce the cost to taxpayers of complying with the tax code
- Improve the ability of the IRS to administer the tax law efficiently
- Reduce tax evasion and inadvertent mistakes
- Provide taxpayers with better service
- Protect taxpayers from identify theft and privacy invasions
- Ensure that all taxpayers are treated fairly and similarly situated taxpayers are treated similarly

Some specific concerns about tax administration today include the following:

- **Overall Complexity:** Taxpayers find the tax system to be too complex, time consuming, and costly. Taxpayers are so overwhelmed by the tax code that about 59% now pay preparers to file for them, and another 30% use tax preparation software to streamline the filing process. In 2010, individuals and businesses paid \$168 billion to comply with the tax code, which equals 15% of total income tax receipts. Critics argue this complexity obscures understanding of the tax code and undercuts voluntary compliance.
- **Taxpayer Identity Theft:** Criminals use a variety of methods to obtain taxpayer identification numbers and then file fraudulent tax returns to collect tax refunds. Victims of tax identity theft experience substantial difficulty correcting fraudulent returns and obtaining tax refunds that they are rightfully owed.
- **The Tax Gap:** The tax gap is the difference between what taxpayers pay to the IRS and what they owe under the law. The most recent IRS net tax gap estimate (based on 2006 data) is \$385 billion. This is an underpayment of approximately 14% of the estimated correct tax liability. The tax gap is the result of both conscious tax evasion and inadvertent mistakes, many of which are due to the complexity of the tax code. The amount of information reporting, and whether or not withholding is required, can have a significant effect on the tax gap. The IRS estimates that when income is subject to substantial information reporting and withholding (such as wages and salaries), about

99% of the income is reported to the IRS. When income is subject to some information reporting and no withholding (such as capital gains and alimony income), about 89% of the income is reported. When income is subject to neither information reporting nor withholding (such as nonfarm, sole proprietor income and royalties), only about 44% of the income is reported.

- **Problematic Filing Schedule:** Many note that the current filing deadlines do not permit the IRS or taxpayers to access third-party information on a timely basis. As a result, the current system limits the information at taxpayers' disposal to file accurate and timely returns, and it limits the ability of the IRS to verify information on taxpayers' returns before refunds are paid.
- **Regulation of Tax Return Preparers:** Due to tax law complexity, taxpayers increasingly rely on third parties to prepare their returns, thereby increasing their exposure to preparer misconduct or error. In 2011, the IRS started regulating tax return preparers by requiring registration and imposing minimum competency standards. The District Court of Washington, DC recently ruled (*Loving*, No. 12-385 (D.D.C. 1/18/13)) that the IRS lacks the authority to regulate tax return preparers. If the IRS does not prevail in its appeal of the *Loving* case, it will lose an important tool to increase tax compliance and protect taxpayers from unethical tax return preparers.

## **REFORM OPTIONS**

### **I. COLLECTION AND ENFORCEMENT**

#### **1. Reduce tax fraud and taxpayer identify theft**

- a. Limit access to personal identifying information, such as SSNs of recently deceased individuals on SSA's Death Master File (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume 1; S. 3432, Identity Theft and Tax Fraud Prevention Act, sponsored by Sen. Bill Nelson; H.R. 3475, Keeping IDs Safe Act of 2011, sponsored by Rep. Johnson)
- b. Partner with third parties, such as banks and bank card providers, to share successful practices to combat identity theft and tax fraud (Network Branded

Prepaid Card Association testimony at Senate Finance Subcommittee Meeting on Tax Fraud, March 20, 2012)

- c. Improve information sharing with federal, state, and local law enforcement (S.3432, Identity Theft and Tax Fraud Prevention Act, sponsored by Sen. Bill Nelson)

## **2. Reduce the tax gap**

- a. Restructure and simplify the penalty system to improve voluntary compliance and ease the administrative burden of the system, for example, by consolidating similar penalties (National Taxpayer Advocate, 2008 Annual Report to Congress)
- b. Improve, automate, and enhance information reporting by third parties to the IRS (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper; GAO-12-651T) through, for example, the following reforms:
  - i. Require information reporting by federal, state, and local governments on non-wage payments for property or services (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
  - ii. Improve information reporting by financial institutions on unreported and underreported financial accounts (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
  - iii. Require additional information on home mortgage interest (GAO-09-769; GAO Testimony at the Senate Finance Committee on March 26, 2012; S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
  - iv. Clarify information on Schedule C (GAO-09-238)
  - v. Require e-filing for certain employee benefit plan information returns and reports (S.1289, TAX GAP Act of 2011, sponsored by Sen. Carper)
  - vi. Require life insurance companies to report certain transactions, including sales, transfers, and benefits (S.2048, A bill to... clarify the tax treatment of certain life insurance contract transactions..., sponsored by Sen. Casey)
- c. Limit the ability of seriously delinquent taxpayers to avoid paying taxes through, for example, the following reforms:
  - i. Revoke or deny passports of seriously delinquent taxpayers (Moving Ahead for Progress in the 21st Century Act, 2012; score: \$743 million; provision was marked up and approved by the Finance Committee on February 7, 2012)

- ii. Require Medicare contractors to screen prospective Medicare providers for unpaid taxes, including obtaining consent from providers to disclose federal tax debts (GAO-08-618)
  - iii. Authorize a 100% continuous levy on payment to Medicare providers and suppliers who neglect or refuse to pay taxes (S.3457, Veterans Jobs Corps Act of 2012, sponsored by Sen. Bill Nelson)
- d. Ensure that the IRS has authority to oversee paid preparers by providing clear statutory authority for the IRS to regulate tax return preparers if the IRS loses its appeal in the *Loving* case
- e. Enhance privacy protections in IRS whistleblower programs by, for example, requiring the redaction of third-party return information in administrative and judicial proceedings for a whistleblower claim (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume One)
- f. Adopt policies to increase voluntary compliance based on behavioral economics findings, such as communications strategies emphasizing social norms (National Taxpayer Advocate, 2007 Annual Report to Congress, Volume II; Behavioural Evidence & Insight Team, United Kingdom)
- g. Provide IRS with additional resources to carry out enforcement, enhance taxpayer services, and modernize their information technology systems (GAO-12-651T; The President's Budget for Fiscal Year 2013; CBO estimated the President's proposal for boosting enforcement activities as resulting in \$20 billion in net non-scoreable budgetary savings) (Note: This is outside of the Finance Committee's jurisdiction)

### **3. Improve the taxpayer experience in IRS audit and collection procedures**

- a. Increase collection of delinquent tax liabilities by making it easier for taxpayers to structure payment plans with the IRS
- b. Provide waivers for user fees when installment agreements use automated withdrawals (H.R. 1528, the Tax Administration Good Government Act, sponsored by Rep. Rob Portman)
- c. Codify and improve the correspondence audit process (National Taxpayer Advocate, 2011 Annual Report to Congress, Volume 2; Testimony of Troy Lewis at the Senate Finance Committee, April 26, 2012)

- d. Expand the IRS virtual service pilot program (Virtual Face-to-Face Audits, National Taxpayer Advocate Blog; Testimony from Teresa Thompson at the Senate Finance Committee, April 26, 2012)
- e. Strengthen taxpayer privacy rights, particularly regarding digital information (GAO-13-350)

## **II. FILING PROCESS**

### **1. Enable the IRS to verify information on taxpayer returns against third-party information as returns are processed**

- a. Establish a system of filing deadlines that ensures timely receipt of reliable third-party information by taxpayers and the IRS, for example by changing due dates for returns (S.420, Tax Return Due Date Simplification and Modernization Act of 2013, sponsored by Sen. Enzi; American Institute of Certified Public Accountants (AICPA), AICPA Recommends Change to Return Due Dates; Testimony of Troy Lewis at the Senate Finance Committee, April 26, 2012)
- b. Improve the process for filing information returns with the IRS by, for example, requiring e-filing information returns directly to the IRS instead of or at the same time as the Social Security Administration (other suggestions listed in GAO Testimony to the Senate Finance Committee on June 28, 2011)
- c. Provide the IRS with additional time to process returns more accurately by, for example, extending the refund-due date beyond which the IRS must pay interest from 45 days to 60 days
- d. Authorize the IRS to use external data (e.g., the National Directory of New Hires) to verify employment (S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sen. Wyden; S.1289, TAX GAP Act of 2011, Sec. 503, sponsored by Sen. Carper)
- e. Require that electronically-prepared paper returns printed and sent to the IRS include a 2D barcode, which is required by many states, to increase the speed and accuracy of paper return processing (GAO-08-38, S.1289, TAX GAP Act of 2011, Sec. 204, sponsored by Sen. Carper)

## **2. Reduce compliance costs by having the IRS fill out simple returns for taxpayers**

- a. For taxpayers with relatively simple returns, require the IRS to pre-fill the returns with information it has received from third parties and preliminarily calculate tax liability; taxpayer could either accept and sign this return or make needed changes (California's "Ready Return" program; President's Economic Recovery Advisory Board, 2010; Tax Policy Center, Ways to Improve the Tax System: Return-Free Filing)

### **III. SIMPLIFICATION**

Well-coordinated, comprehensive tax reform will reduce the need for many complex provisions to limit the ability of some taxpayers to benefit from certain deductions, credits, exemptions, and exclusions. The following general elements of our current tax system could be repealed or greatly simplified as part of comprehensive tax reform. Subsequent papers will compile simplification options in specific areas.

#### **1. Repeal provisions that require taxpayers to calculate their tax liability multiple times**

(JCT document JCS-3-01; S.727, Bipartisan Tax Fairness and Simplification Act of 2011, sponsored by Sen. Wyden; Bowles-Simpson Zero Plan Chairmen's Mark; Rivlin-Domenici Bipartisan Policy Center Tax Reform Plan; President's Economic Recovery Advisory Board, 2010; Tax Foundation, The Economic and Policy Implications of Repealing the Corporate Alternative Minimum Tax)

- a. Repeal the individual Alternative Minimum Tax (AMT)
- b. Repeal the personal exemption phase-out (PEP)
- c. Repeal the phase-out of itemized deductions (Pease)
- d. Repeal the corporate AMT

#### **2. Simplify and conform definitions in tax code**

- a. Establish uniform definitions of terms such as "qualifying child", "modified adjusted gross income", and "related party" (Tax Policy Center, Incremental Reform: What are Ten Ways to Simplify the Tax System?)

### **3. Identify and remove deadwood provisions**

- a. Repeal provisions that are no longer necessary including, for example, the more than 100 “deadwood” provisions identified by JCT (JCT document JCS-3-01)

## **IV. MISCELLANEOUS**

### **1. Update the taxpayers’ bill of rights**

- a. Codify and update taxpayer bill of rights that would explicitly detail the rights and responsibilities of taxpayers, such as the right to confidentiality and the obligation to pay taxes on time (National Taxpayer Advocate, 2011 Annual Report to Congress)

### **2. Improve Tax Court operations and protect taxpayer rights before courts**

- a. Improve taxpayer access to judicial forums, for example, by changing filing periods, venue appeals, and evidence rules; strengthen judicial administration and accountability, for example, through changes to rules governing judicial appointments, tenure, and the retirement system (US Tax Court Legislative Proposals Submitted to the 113<sup>th</sup> Congress)

### **3. Improve government transparency by providing taxpayers with a receipt for taxes paid**

- a. Require the IRS to provide every taxpayer who files an individual tax return with an itemized receipt; the receipt could show the taxpayer’s average tax rate, marginal tax rate, the value of the tax expenditures they claim, and/or an allocation of their tax payments to the major spending categories in the federal budget (S.437, Taxpayer Receipt Act of 2011, sponsored by Sen. Bill Nelson, and as H.R. 1527, sponsored by Rep. Quigley; Third Way, Idea Brief: A Taxpayer Receipt)

#### **4. Streamline JCT's review of large refunds**

- a. Simplify the process for JCT reviewing large refunds by, for example, raising the threshold for refunds that JCT must review above \$2 million and more clearly articulating the role of JCT in the large refund review process (JCT)