

Tax Policy and Issues of Complexity

Professor Annette Nellen
SJSU MST Program
http://www.cob.sjsu.edu/nellen_a/



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What is tax policy?

- Considerations involved in design of a tax system and its components.
 - The appropriate type and mix of taxes.
 - Tax base.
 - Rate structures.
 - Who is the taxpayer?
 - Directly and indirectly.
 - Administrative and compliance structure.
 - Intergovernmental considerations.
- And ... there may be legal constraints (constitutional, statutory, judicial) that affect all of the above.

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Tax policy/design should lead to ...

- A “workable” tax system that ...
 - Taxpayers understand.
 - Allows for effective and efficient funding of the desired level of government spending.
 - Allows for reasonable predictability for creating government budgets.
 - Support of the jurisdiction’s economic, societal, and environmental goals (the tax system should not work in opposition to these goals).

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Principles of good tax policy

- Tools that help identify and shape the appropriate design or policy for a tax system

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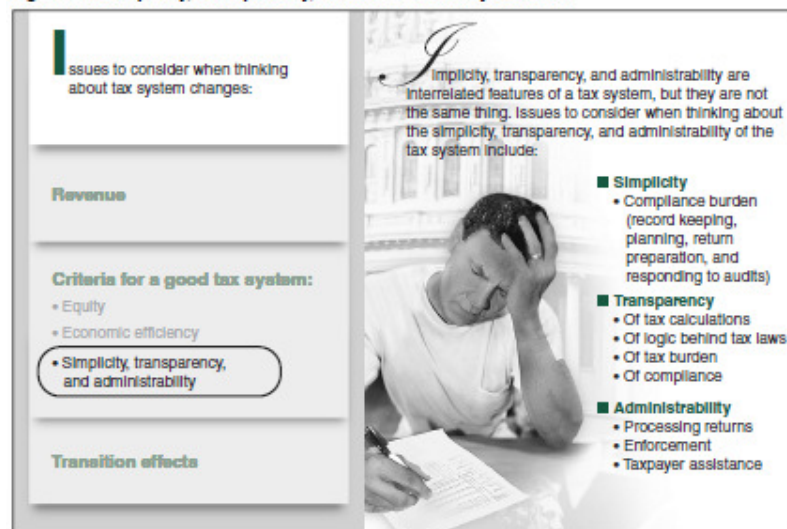
Simplicity

- “The tax law should be simple so that taxpayers understand the rules and can comply with them correctly and in a cost-efficient manner.” [AICPA]

<http://www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/TAXLEGISLATIONPOLICY/Pages/TaxReform.aspx>

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Figure 13: Simplicity, Transparency, and Administrability Overview



GAO, *Understanding the Tax Reform Debate*, 9/05, p. 45

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Is the federal tax system simple?



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Do you know?

- College student with a job.
 - Is he a dependent?
 - Is he subject to the kiddie tax if also has unearned income?
 - If entitled to any higher education credit or deduction, does he claim it or does parent?
 - Could he be eligible for the EITC?

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Do you know?

- How much first year depreciation is available on:
 - Computer purchased by a sole proprietor?
 - Self-constructed asset of a Fortune 500 company?
 - Off-the-shelf software?
 - Passenger automobile weighing $\leq 6,000$ pounds
 - Passenger automobile weighing $> 6,000$ pounds
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Do you know?

- How to source income from customer use of software in the cloud if server is in Ireland and customers are in every state and company headquartered in Nevada?
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Do you know?

- Which of these is subject to sales tax collection in California?
 - Maintenance contract sold with custom software?
 - Hot coffee to go
 - Shipping and handling
 - Equipment to manufacture solar panels
 - Items sold on eBay by individual with over 50 sales during the year

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"The most serious problem facing taxpayers is the complexity of the Internal Revenue Code."

National Taxpayer Service, 2008 Annual Report to Congress, Vol 1, page 3

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"If tax compliance were an industry, it would be one of the largest in the United States. To consume 7.6 billion hours, the "tax industry" requires the equivalent of 3.8 million full-time workers."

National Taxpayer Service, 2008 Annual Report to Congress, Vol 1, page 3

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Many rules too specialized

How many people know that ...

- There are special rules for married parents who live apart for last 6 months of the tax year that may enable them to be considered as "unmarried."
- The support test is different for a dependent who is your child versus a "qualifying relative."
- Age varies among rules. A child up to age 23 may need to use their parent's tax rate to calculate their tax liability, although the child care credit can only be claimed if the child is under age 13. Dependent might be up to age 23 (if FT student) or 18 (if not FT student), but child credit only allowed up to age 16.
- Form 1099-C for cancelation of debt income might not be taxable.
- While Schedule A says you can deduct state taxes if you itemize, you won't get the deduction if AMT applies.

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Causes of complexity - 1

- Too many provisions – multiple tax relief measures with similar purposes. For example, family measures (filing status, dependency, child care credit, child credit, EITC), higher education, retirement, depreciation,
- Using the tax law to remedy all problems
- Adding new provisions without removing any old provisions

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Causes of complexity - 2

- Trying to make the law more progressive or less regressive without changing the tax rate or tax rate structure. For example, phase-outs, partially refundable credits for some individuals (such as child credit and AOTC)
- Using the same word but with different meanings – Modified AGI, small business, others
- Ignoring existing rules. For example, odd due date rules for FBAR, creating a child credit rather than increasing the dependency deduction
- Overly complicated approaches to prevent possible abuses. Examples – kiddie tax, AMT

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Causes of complexity - 3

- Desire for accuracy
 - Example – not excluding small amounts of CODI, kiddie tax calculation
- 2 systems – regular and AMT, rather than reducing number of tax deductions, exemptions and credits
- Budget related problems – temporary provisions that are continually renewed

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Solutions – how to simplify

- Stop enacting complicated provisions
- Sacrifice accuracy for simplification where appropriate
 - EX – Notice 2011-72 allowing personal use of cell phones by employees to be de minimis fringe benefit
- Phase out unnecessary special rules that
 - Serve no purpose
 - EX – interest deduction on second home and home equity debt
 - Can be addressed outside of the tax law
 - EX – education incentives

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More solutions ...

- Use complexity analysis called for by IRS Restructuring Act of 1998 and AICPA
- Always ask – is there a simpler way to accomplish what we are trying to do? Did we ask tax practitioners for their advice?

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Also consider ...

- Broader base and lower rates more likely to meet principles of good tax policy including simplicity.
- Administrative structure – forms, filing procedures, good use of technology
 - Information on tax forms can help. EX – Sch E for rental – include note or question about not depreciating land
- How the process of changing the laws causes complexity – need to improve the budget process.
 - Ex – temporary provisions; retroactive reinstatements, etc.
 - Ex – changes tied more to revenue needs than good tax policy, such as changes in amount of estimated taxes

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Complexity

- Nat'l Taxpayer Advocate - the "confounding complexity of the tax code" is the most serious problem facing taxpayers
- 2003 – 56% of individuals and over 70% of those claiming EITC had a paid preparer
- Only 16% of individuals know how long to live in a home to get an exclusion
- Code and regulations – over twice as long today as 20 years ago
- 1040EZ instruction – 40 pages long
- High costs of complexity
 - Per Dr. Joel Slemrod (3/05 testimony to President Bush's Tax Reform Panel):
 - Annual compliance costs = \$125 billion
 - That's 12x larger than IRS operating budget
 - Harm to individuals and small businesses

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QUESTIONS



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AICPA button

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