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COMPLEXITY AND COMPLIANCE ISSUES IN THE U.S. TAX SYSTEM

INTRODUCTION

Today, Americans are looking for the “big easy,” and smart businesses have capitalized on this phenomenon. McDonald’s has sold their billion hamburgers to fast-paced Americans who do not have time to cook at home, and since fast was not fast enough, so the drive-thru came about. The computer industry made its computers “user friendly” partly because people were not taking the time to read the manuals. Meanwhile, our tax system has grown increasingly complex and burdensome. In a November 6, 1987 speech before the Central Region Bar Liaison, Internal Revenue Commissioner Lawrence B. Gibbs stated “[t]axpayers are accustomed to one-stop service in everyday life and expect the same from us. But as our team (of employees addressing taxpayers’ and practitioners’ complaints) learned, they weren’t getting it”.¹

On October 22, 1986, The Tax Reform Act of 1986 became law, introducing the most comprehensive revision of the Internal Revenue Code since 1954, and complexity is still the hallmark. Noncompliance with the tax system is costing the United States \$100 billion per year.² This \$100 billion represents two-thirds of the current federal budget deficit.

This article is a compilation of views about the current tax system. In addition, this article seeks to identify what we are or should be doing about the complexity and compliance problems inherent in our tax system, and offers approaches from various groups posed to alleviate some of the complexity and compliance problems.

COMPLEXITY

It is certainly a given that the U.S. tax law has become increasingly complex over the years. The following chart looks at the changes within the Code beginning

¹ U.S. Tax Week, “Commissioner Comments on Current Compliance Issues,” No. 48, Nov. 23, ‘87, p. 739.

² ABA Commission on Taxpayer Compliance, Special Report: ABA Commission on Taxpayer Compliance: Summary and Recommendations, 37 Tax Notes, Nov. 16, 1987, pp. 731-33.

with 1976:

<u>Statute</u>	<u>Number of Code Subsections Affected</u>
Tax Reform Act of 1976	1,849
Revenue Act of 1978	664
Economic Recovery Tax Act - 1981	483
Tax Equity and Fiscal Responsibility Act - 1982	530
1984 Deficit Reduction Act	2,245
1984 Retirement Equity Act	44
Tax Reform Act of 1986	2,704

TOTAL:	8,519 ³

There is a price to pay for the ever changing tax code. Tax reform will cost the Service an estimated \$106,485,000, for fiscal year 1988. Eighty million of this amount will come from new funds requested for implementation.⁴ The IRS will issue 49 new forms and 10 new publications resulting from the Tax Reform Act of 1986. Many taxpayers on the tax rolls face numerous new or revised provisions as a result of this legislation, including changes in depreciation, allowable interest deductions, "kiddie" tax, IRA limitations, original issue discount, alternative minimum tax, pension distribution rules, and business expenses.

Change and complexity hamper the Service's ability to provide technical guidance on a timely basis. The Service projects that the number of telephone requests for 1988 will increase by about 10 million over 1987, requests for assistance by walk-ins by one-half million, and assistance via tele-tax by one million.⁵ The General Accounting Office examined the IRS telephone assistance program in 1986, and found that the agency answered only seventy-nine percent of the GAO's questions correctly. The IRS vowed to improve. But, in January of 1987, MONEY Magazine conducted a survey which suggested that the IRS had actually gotten

³ Commissioner's Advisory Group December 9th and 10th, Complexity and Change, Tax Notes Today, March 16, 1988.

⁴ *Id.*

⁵ *Id.*

worse. The assistors were right only slightly more than half the time. Sixty percent of the assistors were not aware that the cost of sending a child to an overnight summer camp could be counted toward the child care credit in 1987, and seventy percent did not know that interest paid on a loan used to buy tax-exempt bonds is not deductible.⁶

In addition, the more complex the tax system, the more thinly spread are the resources of the IRS. Former IRS Commissioner Egger stated, “[o]ne reason we are auditing fewer returns is that they have become more complex and take longer to examine.”⁷

It becomes increasingly difficult for practitioners as well as taxpayers to stay abreast of the changes in the tax law. A 1987 MONEY Magazine examination of fifty tax preparers nationwide shows that the new tax law is causing all sorts of problems for those who make their living filling out tax returns. The results of the survey found:

1. The fifty professionals computed fifty different amounts of tax due for the hypothetical family. Their bottom lines varied by as much as fifty percent.
2. The preparers are still uncertain about the nuances of the new tax law.
3. In cases where the law itself is unclear, the professionals are making up rules of their own that differ greatly. Because there are an unprecedented number of gray areas, it is more likely than ever that taxpayers could end up paying a higher tax bill - or risking an audit.
4. Professional tax preparers, even the most expensive ones, are not immune from making careless mathematical mistakes.

One major cause for the differing bottom lines is the gap in the tax law itself. For some situations, there are no clear rules. Aggressive preparers tried to save as much tax for the family as they could justify. But in so doing, they increased the risk that the IRS would audit the family’s return. Conservative preparers were more inclined to let the family pay higher taxes.⁸

The IRS interviewed 1,772 tax preparers between May and July of 1986, and drew samples from 42 million individual returns. The survey indicated the extent of

⁶ G. Anrig, “So How Come The IRS Knows All The Answers When You Get Audited?”, MONEY, March ‘88, p. 136.

⁷ U.S. News & World Report, April 18, ‘82, p. 46.

⁸ G. Anrig, “Even Seasoned Pros Are Confused This Year,” MONEY, March ‘88, pp. 134-138.

practitioners' familiarity with the IRS collection procedures:

1. eighty-two percent were highly or somewhat familiar with liens;
2. eighty-three percent are highly or somewhat familiar with the notice of levy;
3. sixty-three percent were highly or somewhat familiar with seizures of property;
4. sixty-one percent were highly or somewhat familiar with IRS summons;
5. sixty-six percent were highly or somewhat familiar with the 100 percent penalty on withholding of taxes, and
6. fifty-nine percent were highly or somewhat familiar with offers-in-compromise.⁹

The level of unfamiliarity is particularly high for the last four issues. Commissioner Gibbs stated "[c]onsider the last one - preparers of almost four out of ten returns are unfamiliar in whole or in part with an offer in compromise. That's the procedure whereby the taxpayer makes an offer of a lesser amount of tax owed. If a taxpayer or representative can make a case, the offer can be accepted. Last year, one out of five offers were accepted."¹⁰ It seems that the IRS prefers that one has their return prepared by a preparer with an affiliation with a professional association. The IRS survey showed that only fifty-nine percent of the 42 million returns were prepared by persons affiliated with a professional association. Commissioner Gibbs commented on this, saying "[i]t definitely raises a communication issue for the IRS. If there is no professional affiliation, what other channels can we use for keeping in touch with return preparers and reinforcing our messages?"¹¹

The process lends itself to complexity. In an article entitled "The Final Section 704 (b) Regulations: Special Allocations Reach New Heights of Complexity," authors/lawyers Close and Kusnetz try to make sense of the 704 regulations. On September 8, 1986, the Treasury Department amended the 704 regulations to conclude a ten year process that had begun with the amendment of code section 704 by the Tax Reform Act of 1976!¹²

The process lends itself to political manipulation. Congress has discovered

⁹ U.S. Tax Week, "Commissioner Gibbs on IRS Study of Practitioners," No. 37, Sept. 7, '87, pp. 562.

¹⁰ *Id.* at 562.

¹¹ *Id.* at 562-63.

¹² M. Close & D. Kusnetz, "The Final 704(b) Regulations: Special Allocations Reach New Heights of Complexity," ABA, 40 The Tax Lawyer, Winter '87 pg. 307.

that deductions and exemptions offer a politically attractive means of conferring special treatment. The proliferation of tax preferences, whether to advance desirable social policy or merely to cater to political constituents, has escalated in recent years; the annual tax expenditure budget is now estimated at \$265 billion. Former Treasury Secretary Regan remarked “[t]he tax law has accumulated many patchwork provisions, often designed to meet temporary needs of particular interest groups, that have added to the complexity of the system and distorted economic choices.”¹³

The Internal Revenue Service recognizes the confusion that taxpayers have when a tax law change goes into effect. In March 1987, the Internal Revenue Service announced that taxpayers would not be penalized if they were underwithheld for 1987 on their taxes on wage income as long as they made a good-faith effort to comply with the law by filing a new withholding statement. The Internal Revenue Service said it was waiving the penalty for 1987 because many taxpayers had difficulty computing their withholding due to the major changes in the tax law made by the Tax Reform Act of 1986.¹⁴

The process lends itself to commentary on effective changes that ranges from the satirical to the “high-tech” future version of what our tax system might look like. On the lighter side, author/lawyer Gerald Skoning suggests “the tax allocation program” where Tommy Taxpayer, a former Marine Corps Officer, could pass over the blanks for social welfare programs and allocate eighty percent of his total tax to Strategic Defense Initiative research, ten percent for military aid to the Contras, and ten percent to bring two more battleships out of mothballs. His neighbor Tammy Taxpayer, who worked in the Peace Corps, could earmark seventy-five percent of her taxes for public aid and Medicare, fifteen percent for endowment of the arts, and ten percent for support of the United Nations. Other taxpayers who remain confused or apathetic about government spending priorities, can check the box marked “unrestricted,” and let the bureaucrats and politicians spend their taxes any way they like.¹⁵

Author/lawyer John A. Newman takes a futuristic look at the tax system in his report entitled “Constructing a New Tax Policy Based on the Computer.” In this article, Newman suggests that a computer based electronic fund transfer system (EFTS) could provide a foundation for the imposition of a low rate, comprehensive transfer tax that could serve as a possible substitute for the federal income tax. He predicts that within six years, an EFT network could be in place that could generate more revenue than the federal income tax. Such a tax could be collected automatically at the time of all transfers and would eliminate various individual, corporate, partnership, trust and estate tax returns under the present income tax system.¹⁶

¹³ Statements of Donald Regan, Tax Notes, Feb. 6, 1984, pp. 439-40.

¹⁴ U.S. Tax Week, “IRS Waives Penalty for Underwithholding for 87,” No. 2, Jan. 11, 1988, p. 23.

¹⁵ U.S. News & World Report, April 18, '82, p. 46.

¹⁶ J. Newman, “Special Report: Constructing A New Tax Policy Based On The Computer,” Tax Notes, July 23, '84.

COMPLIANCE -- PERCEPTIONS

The process lends itself to noncompliance. The success of a system based upon voluntary self-assessment is dependent upon United States taxpayers willing to disregard their inclination to avoid tax. However, the 1980 Gallup Poll confirms that regardless of the true level of taxation, taxpayers over the last three decades have always considered taxes to be too high.¹⁷ In his article entitled "Noncompliance With U.S. Tax Law - Evidence on Size, Growth, and Composition," author Henry dispels the myth that noncompliance is largely the province of busboys, cabbies, field hands, and street vendors. He states that the overwhelming share of noncompliance is attributable to property and entrepreneurial incomes (such as interest, dividends, capital gains, rents, and royalties).¹⁸

In 1984, the Internal Revenue Service commissioned the firm of Yankelovich, Skelly & White to do a comprehensive poll on taxpayer attitudes. According to their findings, eighty percent agree the "present tax system benefits the rich and is unfair to the ordinary working man or woman." The study also found that one-third of all taxpayers are clearly receptive to the idea of tax cheating at some level. An additional one-third is strongly opposed to tax cheating and the remaining one-third appear ambivalent on the issue; although the people in the latter group are susceptible to being swayed either way.¹⁹ These findings correlate with Henry's, for when one-third of all taxpayers are receptive to cheating and another third are ambivalent, the tax system that is based on self-assessment is in trouble.

In its publication of proceedings of a March 1983 meeting, the Tax Section of the ABA stated, "[t]he current danger is that we are approaching the point at which noncompliance becomes socially acceptable and therefore uncontrollable."²⁰ Former Commissioner Egger believes that the solution lies in making our tax laws fair. In a May, 1985 speech to the Commonwealth Club, he stated "[c]omplexity and inequity are gnawing away at the system's backbone."²¹

In an article entitled "Compliance with the Law: A Decision Making Approach to Taxpaying," author John S. Carroll of Sloan School of Management, M.I.T., states that it seems clear that we have created a societal climate that prevents stability for many taxpayers. Frequent changes in the tax laws, the economic incentives to innovators who create legal tax avoidance strategies, the publicity given to corporations and the wealthy who strive to reduce their taxes, the public debate over

¹⁷ *Id.*

¹⁸ J. Henry, "Noncompliance With U.S. Tax Law - Evidence Of Size, Growth and Composition," (paper presented at Invitational Conference on Income Tax Compliance, March 1983) 37 *Tax Lawyer*, Fall 1983, p. 53.

¹⁹ F. Haskell, "Special Report: Tax Compliance and Tax Fairness," *Tax Notes*, May 13.

²⁰ *Id.*

²¹ *Id.*

the fairness and effectiveness of taxes, the societal emphasis on personal well-being and reemphasis of communal motives all push in the direction of thinking about taxpaying more, making the taxpaying process more costly and frustrating, and defining one's behavior as "tax avoidance."²²

COMPLIANCE -- COST

Just how costly is the compliance aspect for United States citizens? Joel Slemrod has made a quantitative study to help answer this question. He suggests that the critical aspect of complexity is the time and expense involved in completing the tax return, or compliance cost, including not only complying with the filing requirement, but also identifying and documenting the deductions, credits, and reductions in taxable income to which he or she is entitled.²³ A survey he conducted indicated that the average taxpayer spent 21.7 hours of their own time on tax filing, valued (using after-tax wage rates) at \$231 dollars and \$44 dollars in additional expenses, for a total of \$275 per household. Multiplying these averages by the 97 million filers in 1982 yields 2.13 billion hours and a total resource cost of \$26.7 billion dollars. These costs associate with 1.4 percent of the aggregate adjusted gross income, and more than 7 percent of total federal and state income tax revenue.²⁴ For the self-employed individual the costs are even higher; thirty-five additional hours were required, and the total resource cost of the self-employed individual was more than \$400 dollars.²⁵

COMPLIANCE AND EDUCATIONAL ASPECTS

Another aspect of compliance is the lack of capacity to comply. The U.S. General Accounting Office estimated that in 1976 over six million taxpayers who should have filed income tax returns did not do so. Its finding that the average educational level of the nonfilers was below the national norm suggested to them that the reason for nonfiling was often that the process was too complicated to be understood.

The Center for Taxation Studies at The University of Akron recently looked at the correlation between lack of reading skills and compliance with the tax laws. Using the Fry Readability Formula they found that while the reading grade level required for the Wall Street Journal was 7.10, the reading grade levels required for Forms 1040EZ and 1040 instruction booklets were 8.45 and 7.85, respectively.²⁶

²² J. Carroll, "Compliance With The Law: A Decision Making Approach To Taxpaying," 11 Law & Human Behavior, Dec. '87 pp. 329-30.

²³ J. Slemrod, "Complexity Compliance Costs and Tax Evasion," (unpublished paper) University of Michigan, January, 1988, p. 2.

²⁴ *Id.* at 8.

²⁵ *Id.* at 11.

²⁶ U.S. Senate Finance Committee Subcommittee on Penalties. Testimony by University of Akron Center For Taxation Studies, Student Tax Clinic, pp. 19-20.

Using the U.S. Department of Education statistics, the Center's report found the following percent of the American population possessed the reading skill necessary to understand the information in the 1040EZ and 1040 instructions:

<u>Class</u>	<u>Percentage</u>
Black Racial Origin	19.8
Hispanic Racial Origin	37.0
Persons with less than high school education	11.0
Persons with some high school education	22.0
High school graduates	50.2
Graduates with two or more years postsecondary	82.8 ²⁷

The conclusion is manifest in the data; if taxpayers cannot read and comprehend the instructions, how can the government expect compliance?

CONCLUSION

The long term solution to part of the complexity problems inherent in our tax system should focus on increasing the educational levels of all Americans. That is a feat which this article will not attempt to address. However, a short term solution can and must involve increasing taxpayer knowledge about taxpayer compliance. But how do we go about this task? Because taxpayer compliance depends on citizen's knowing what is required of them, the Internal Revenue Service has a dual role. Not only does the Service have a traditional enforcement role in detecting and punishing noncompliance, the Service must also take the lead in educating taxpayers and helping them comply. Education and assistance functions have not, however, had a high priority when the Internal Revenue Service budget is allocated, and educational outreach activities have not received adequate and consistent support.²⁸ The following are solutions aimed at minimizing the complexity and compliance problems inherent in our current tax system:

The Special Report by the ABA Commission on Taxpayer Compliance has the following recommendations:

1. There should be an expansion of outreach activities, including more

²⁷ *Id.*, at 20.

²⁸ Commissioner's Advisory Group December 9th and 10th, Complexity and Change, Tax Notes Today, March 16, 1988.

appearances by Internal Revenue Service officials on the media and in public forums, and more vigorous publicity about enforcement activities.

2. Information programs should, wherever possible, be targeted to reach particular occupational or industry groups, and should pay special attention to small businesses and the self employed.
3. Educational efforts should also be directed at immigrants and other first-time taxpayers and at school-age children.
4. Increased resources should be devoted to improving tax forms to encourage compliance, including developing new instructions or forms for specific occupations and industries.
5. The Internal Revenue Service's Taxpayer Service function should be improved to ensure that taxpayers' questions are accurately and promptly answered and the taxpayers are made aware of the availability of assistance.²⁹

The Commissioner's Advisory Group came up with additional recommendations at their March 16, 1988 meeting:

1. The Internal Revenue Service should expand its role in advising Congress on the administrability and complexity of tax reform proposals.
2. Develop a "Compliance Impact Statement" or an "Administrability/Complexity Index" to be reviewed by Administration decision-makers and Congressional committees and staff, along with the budget and revenue effect estimates now provided by the OMB and the Congressional Budget Office. This statement would report for each major provision on such factors as:
 - Number of taxpayers affected by the provision.
 - Most recent time the provision had been changed and report on the frequency of change over the last five to ten years.
 - Expected regulatory needs (length and complexity, time required, staff years).
 - COSTS and EFFECTS on tax administration, including forms and instructions, computer pro-

²⁹ *Id.*

- grams and processing, audits, collection, regulatory
 - Implementation cost estimate
 - Effect on taxpayers' recordkeeping and cost of taxpayer compliance.
3. Tax writers should be educated on the effect of complexity on administrability and compliance.
- Commission a study to determine the effect of complexity on compliance and the revenue lost from noncompliance.
 - Prepare "position papers" on recent or proposed legislation to demonstrate the complexities.
 - The Commissioner should testify before the tax-writing committees on the administrative and compliance problems inherent in the proposed tax legislation.
4. A general moratorium on substantial tax law changes, except as needed to correct prior legislation, for the next few years would provide the Service time needed to fully implement provisions of existing law and taxpayers time to become comfortable with new compliance features enacted in recent legislation.
5. Congress could provide regulatory authority to issue simplified "safe-harbor" rules for complex provisions.³⁰

For the specific protection of low income taxpayers, the Center For Taxation Studies at the University of Akron has suggested the following:

1. Representation should be provided to taxpayers before penalties and interest are added.
2. The mandatory services of a qualified representative or ombudsperson should be required before a wage levy.
3. If taxpayers cannot provide their own representation, or be provided with representation, the penalty system should be altered with respect to them.³¹

³⁰ ABA Commission on Taxpayer Compliance, Special Report: ABA Commission on Taxpayer Compliance: Summary and Recommendations, Tax Notes, Nov. 16, '87.

³¹ U.S. Senate Finance Committee Subcommittee on Penalties, Testimony by University of Akron Center for Taxation Studies, Student Tax Clinic, p. 17-39.

These solutions come from different sectors in our society but all have a common theme - the goal of eliminating certain complexity and compliance problems from our tax system. We need to continue to find ways to eliminate complexity and compliance problems in the future. The implementation of these ideas is workable and necessary to manage under the current tax regime.

MARIE RADY

