

Presentation to PERAB Tax Task Force

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Topics Covered

- Taxpayer Compliance Burdens
 - How big are they?
 - What are the main sources?
 - How can they be reduced?
 - Example – savings incentives
- The Tax Gap
 - How big is it?
 - Why is it hard to measure?
 - How can it be reduced?



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Compliance Cost per Individual Taxpayer (2009) – IRS Estimates

<u>Category</u>	<u>Hours</u>	<u>Dollars</u>	<u>Cost at \$25/hr</u>
All returns	17.3	\$225	\$658
Form 1040	21.4	\$280	\$815
1040A or EZ	8.0	\$96	\$296
Non-business	10.7	\$129	\$397
Business	31.9	\$434	\$1232



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Compliance Cost per Individual Taxpayer (2000)– IRS Estimates

<u>Category</u>	<u>Hours</u>	<u>2009 Dollars</u>	<u>Cost at \$25/hr</u>
All returns	25.5	\$190	\$828
Form 1040	33.8	\$262	\$1107
1040A or EZ	9.7	\$55	\$298
Non-business	13.8	\$96	\$444
Business	59.5	\$464	\$1952



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Total Compliance Costs (in billions) for Individual Taxpayer (2009) – IRS Estimates

<u>Category</u>	<u>Hours</u>	<u>Dollars</u>	<u>Cost at \$25/hr</u>
All returns	2.4b	\$31.6b	\$92.4b
Form 1040	2.1b	\$27.6b	\$80.2b
1040A or EZ	0.3b	\$4.0b	\$12.5b
Non-business	1.0b	\$12.5b	\$38.5b
Business	1.4b	\$18.9b	\$53.7b



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Average Time Burden by Activity

	All taxpayers	Non-business	Business
Total Time	17.3 hrs	10.7 hrs	31.9 hrs
Recordkeeping	8.0 hrs	4.1 hrs	16.5 hrs
Tax planning	1.7 hrs	1.1 hrs	3.0 hrs
Form completion	4.3 hrs	3.0 hrs	7.1 hrs
Form submission	1.0 hrs	0.8 hrs	1.2 hrs
All Other	2.4 hrs	1.7 hrs	4.0 hrs



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How Taxpayers Prepare Returns

	1993	1999	2005
Self-prep w/o software	41.3%	24.0%	11.2%
Software	7.8%	19.8%	26.7%
Paid preparer	50.9%	56.2%	62.0%



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Summary Points - Burden

- Costs substantial
 - About 10% of 2009 tax liability
 - But compliance costs have dropped since 2000
- Considerable variation among returns
 - Much higher for business returns (also itemizers and taxpayers on AMT)
- Very few prepare own returns
 - Software reduces costs for those who use it
 - Recordkeeping biggest component of costs
 - Many with simple returns use preparers



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Reducing Compliance Costs

- Substitutes for data intensive provisions
 - Standard deduction vs. itemizing
 - Mileage allowances vs. costs of driving
 - Floors under deductions
- Standardize and consolidate incentives
 - Incentives for saving and higher education
- *De minimus* exemptions
- Less use of income phase-outs
- Require reporting of compliance cost effects of tax law changes
- More radical: dramatically reduce use of tax code for social policy



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Example – Tax-Favored Saving Provisions

- Numerous individual tax-deferred savings vehicles
 - Retirement – IRAs and Roth IRAs
 - Health: HSAs and Archer MSAs
 - Education: Coverdell savings accounts, Qualified tuition programs, savings bonds
 - Exemption of accruals in life insurance
- Employment-related benefits (401k etc.)
- Rollover provisions from traditional to Roth IRAs
- Savers' credits



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Goals of System

- Hybrid income/consumption tax system
 - Consumption treatment of life-cycle saving
 - Capital income tax on high-income individuals
- Subsidize provision for retirement (beyond Social Security) relative to no tax system
 - Tax benefits only for employer contribution (pre 401ks)
 - Anti-discrimination rules
 - Direct saving incentives (credits)



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Solutions

- Consolidate tax-deferred saving accounts and impose aggregate contribution limits
 - 2005 tax reform panel
 - 2 individual plans with separate limits for retirement and other uses
 - Save at work plan with simplified discrimination tests
- Roth or deductible, but not both
 - My preference is deductible
- Refundable savers' credit
- Principles
 - Set uniform limits on tax-favored retirement saving for everyone
 - Encourage employer participation (by simplifying)
 - Use direct subsidies to individuals to promote saving by low tax-bracket workers



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How Big is the Tax Gap?

- IRS Estimates (tax year 2001)
 - Gross tax gap = \$345 billion
 - Net tax gap = \$290 billion
 - 16.3 percent of tax liability
- Simple extrapolations of gross tax gap:
 - 2009 = \$374 billion
 - 2012 = \$538 billion
- Why % gap might change
 - Changes in shares from different tax sources
 - Changes in methodology
 - Changes in taxpayer behavior



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Main Points about the Tax Gap

- The three components are non-filing, underreporting and underpayment
 - The largest by far is underreporting
- Individual income tax accounts for most of tax gap (71%)
 - Underreporting of business income and self-employment tax = 42% of total gap
- Net misreporting percentages vary by degree of information reporting and withholding
 - 1.2% for wages
 - 4.5% for interest and dividends
 - 53.9% for business income with little or no information reporting



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Problems with Current Estimates

- Timeliness of data
 - Individual from TY 2001 random audits
 - Corporate from 1980s audits
- Conceptual issues
 - Adjustments for non-detection
 - Definition of tax gap for large corporations
 - Overstatement of tax liability
 - Flow-through entities
 - International avoidance
- There are ongoing efforts to improve these estimates
 - Individual NRP every year starting with TY 2006
 - New corporate estimates
 - Re-estimation of non-detection



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Reducing the Tax Gap: Traditional Approaches

- More enforcement contacts
 - Less enforcement resources than in 1990s
 - Shift to automated contacts
 - IRS estimates about \$4 of direct revenue per \$1 of spending in long run
 - Indirect effects could be greater
- More document matching
 - Proposals in Bush 2007 budget
 - Proposals in Obama budget
 - Enacted legislation
- All good things (and some already in law), but revenue potential is modest



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Reform and Simplification

- Effects of base-broadening
 - Bringing more income into the base could increase the gap (failing to report income)
 - Reducing deductions and credits may reduce the gap (less opportunity to overstate tax benefits)
- Does a lower tax gap improve fairness?
 - Yes, by preventing some from evading tax
 - No, if it results from making hard to enforce income sources tax-free
- Does simplification reduce the tax gap?
 - Only errors *in the taxpayer's favor* raise the gap
 - But by reducing IRS costs, it could lead to better enforcement



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Will Anything Else Work?

- New Insights or Technology Could Improve Compliance – Examples:
 - Document matching in early 1980s
 - SSNs for dependent children in late 1980s
 - Reduced cash use in economy could help
- Best practice raises the probability of innovation
 - Better IT and data capture in IRS
 - Continued support for random audit studies
 - More flexible government personnel policies
 - Ongoing IRS efforts
 - But no budgetary scoring credit for any of this
- Biggest challenge remains underreporting of income in absence of matching documents



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Data Sources

Slides 3, 5, and 6

Tax year 2009 estimates of average hours and dollars from Federal Register 74-230, Wednesday, December 2, 2009, Notices, Department of the Treasury, pp. 1-7.

Slide 4

Tax year 2000 estimates of average hours and dollars from IRS Tax Burden model, as reported in John L. Guyton, John F. O'Hare, Michael P. Stavrianos, and Eric J. Toder, "Estimating the Compliance Costs of the U.S. Individual Income Tax," *National Tax Journal*, September 2003.

Slide 7

Calculations based on data reported in IRS Taxpayer Usage Studies, 1993-2006, at <http://www.irs.gov/taxstats/article/0,,id=184856,00.html>

Slide 13

Tax Gap figures from Internal Revenue Service, "Tax Gap Map for 2001," as reported in Mark J. Mazur and Alan H. Plumley, Presentation to National Tax Association meetings, May 2007. Figures extrapolated to 2009 and 2012 based on projections of federal receipts reported in Office of Management and Budget, *Budget of the United States Government, 2010, Historical Tables*.

Slide 14

Internal Revenue Service, "Tax Gap Figures," February 14, 2006 at http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf.



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