Complexity: Words in the Tax Code and Regulations

Understanding Complexity and Instability

- Sources of Complexity
  - Duplicative and Overlapping Provisions
    - Savings – multiple defined contribution retirement plans, individual retirement accounts, and education and healthcare savings accounts
    - Education – over a dozen different provisions to encourage education
  - Phase-Outs
  - Expiring Provisions
    - Add to the tax code’s unpredictability
    - Make long term economic planning difficult for individuals and businesses

- The “Complexity Tax”

- Transparency and Fairness
  - Horizontal Equity
  - The “Hazy Tax”
Frequently-Encountered Phase-Outs

- Personal Exemptions (“PEP”)
- Itemized Deductions (“Pease”)
- Child Credit
- Child and Dependent Care Credit
- Adoption Credit
- IRA Contributions
- Saver’s Credit
- Roth IRA Contributions
- Earned Income Tax Credit
- AMT Exemptions
- Social Security Benefits
- Credit for the Elderly and Disabled
- HOPE Credit
- Lifetime Learning Credit
- Tuition Deduction
- Coverdell Accounts
- Student Loan Interest Deduction
Elements of a Phase-Out

- **Threshold Amount**
  - Phase-outs now exist at every income level

- **Phase-Out Rate**
  - Examples:
    - Cliffs
    - Steep descents
    - Gradual declines
  - All create higher tax rates

- **Definition of Income**
  - Examples:
    - AGI
    - Modified AGI
    - Alternative Minimum Taxable Income
  - Require taxpayers to compute their income multiple ways to determine the phase-out amounts.
Phase-Outs Examples

- **Social Security Benefits – Section 86**
  - If modified AGI is:
    1. Less than $32,000, benefits are not subject to Federal income tax.
    2. Between $32,000 and $44,000, taxable benefits are the lesser of: 50 percent of total benefits or 50 percent of the amount by which modified AGI exceeds $32,000.
    3. More than $44,000, taxable benefits are the lesser of 85 percent of total benefits, or the sum of: (a) $6,000, and (b) 85 percent of the amount by which modified AGI exceeds $44,000.

  - “‘Modified AGI’ means AGI determined without regard to this section and sections 135, 137, 199, 221, 222, 911, 931, and 933, and increased by [tax-exempt interest]”

- **IRA Contribution – Section 219**
  - “The amount determined under this paragraph with respect to any dollar limitation shall be the amount which bears the same ratio to such limitation as (I) the taxpayer's [AGI], over (II) the applicable dollar amount [$70,000], bears to [$10,000].”

- **Child Credit – Section 24**
  - **Refundable Portion** – “The aggregate credits allowed . . . shall be increased by the lesser of—
    (A) the credit which would be allowed under this section without regard to this subsection. . ., or
    (B) the amount by which the aggregate amount of credits . . . would increase if the limitation imposed by subsection (b)(3) were increased by the greater of—
    (i) 15 percent of so much of the taxpayer's earned income . . . which is taken into account in computing taxable income for the taxable year as exceeds $10,000, or
    (ii) in the case of a taxpayer with 3 or more qualifying children, the excess (if any) of--(I) the taxpayer's social security taxes for the taxable year, over [the Earned Income Credit].”

  - **Phase-Out at Higher Income** - “The credit allowable...shall be reduced (but not below zero) by $50 for each $1,000 (or fraction thereof) by which the taxpayer's modified [AGI] exceeds [$110,000]. ‘Modified AGI’ means AGI increased by any amount excluded from gross income under section 911, 931, or 933.”
### Social Security Benefits Worksheet

**Before you begin:**
- Complete Form 1040, lines 21, 23 through 25, and 28 through 34a, if they apply to you.
- Figure any write-in adjustments to be entered on the dotted line next to line 35 (see the instructions for line 35 on page 21).
- If you are married filing separately and you lived apart from your spouse for all of 2004, enter “D” to the right of the word “benefits” on line 20a.
- Be sure you have read the Exception on page 24 to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1. Enter the total amount from box 5 of all your Forms SSA-1099 and Forms RRB-1099.

2. Enter one-half of line 1.

3. Enter the total of the amounts from Form 1040, lines 7, 8a, 9a, 10 through 14, 15b, 16b, and 17 through 19, and 21.

4. Enter the amount, if any, from Form 1040, line 9b.

5. Add lines 2, 3, and 4.

6. Enter the total of the amounts from Form 1040, lines 23 through 25, and 28 through 34a, plus any write-in adjustments you entered on the dotted line next to line 35.

7. Is the amount on line 6 less than the amount on line 5?
   - [ ] No
   - [x] Yes, subtract line 6 from line 5.

8. If you are:
   - Married filing jointly, enter $32,000
   - (a) Single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for all of 2004, enter $25,000
   - (b) Married filing separately and you lived with your spouse at any time in 2004, skip lines 8 through 15, multiply line 7 by 85% (.85) and enter the result on line 16. Then go to line 17.

9. Is the amount on line 8 less than the amount on line 7?
   - [ ] No
   - [x] Yes, subtract line 8 from line 7.

10. Enter $12,000 if married filing jointly, $9,000 if single, head of household, qualifying widow(er), or married filing separately and you lived apart from your spouse for all of 2004.

11. Subtract line 10 from line 9. If zero or less, enter -0-.

12. Enter the smaller of line 9 or line 10.

13. Enter one-half of line 12.

14. Enter the smaller of line 2 or line 13.

15. Multiply line 11 by 85% (.85). If line 11 is zero, enter -0-.

16. Add lines 14 and 15.

17. Multiply line 1 by 85% (.85).

18. Taxable social security benefits. Enter the smaller of line 16 or line 17.
   - Enter the amount from line 1 above on Form 1040, line 20a.
   - Enter the amount from line 18 above on Form 1040, line 20b.

---

If any of your benefits are taxable for 2004 and they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See Pub. 915 for details.
IRA Deduction Worksheet

- 21 Boxes
- 10 Lines of Instructions (per spouse)
- 6 Computations
- 1 Stop Sign
- 1 Caution Sign

## IRA Deduction Worksheet—Line 25

<table>
<thead>
<tr>
<th>Before you begin:</th>
<th>Your IRA</th>
<th>Spouse’s IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Complete Form 1040, lines 28 through 34a, if they apply to you.</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>✓ Figure any write-in adjustments to be entered on the dotted line next to line 25 (see the instructions for line 35 on page 31).</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>✓ Be sure you have read the list on page 26.</td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

1. **Were you covered by a retirement plan (see page 26)?**
   - [ ] Yes
   - [ ] No

2. **If married filing jointly, was your spouse covered by a retirement plan?**
   - [ ] Yes
   - [ ] No

   Next, if you checked “No” on line 1a and “No” on line 1b if married filing jointly, skip lines 2 through 6, enter $3,500 ($3,500 if age 50 or older at the end of 2004) on line 7a and 7b if applicable, and go to line 8. Otherwise, go to line 2.

2a. **Enter the amount shown below that applies to you.**
   - Single head of household, or married filing separately and you lived apart from your spouse for all of 2004, enter $55,000
   - Qualifying widow(er), enter $75,000
   - Married filing jointly, enter $75,000 in both columns. But if you checked “No” on either line 1a or 1b, enter $100,000 for the person who was not covered by a plan.
   - Married filing separately and you lived with your spouse at any time in 2004, enter $10,000

2b. **Enter the amount from Form 1040, line 22.**

3. **Enter the total of the amounts from Form 1040, lines 23, 24, 26 through 34a, plus any write-in adjustments you entered on the dotted line next to line 25.**

4. **Subtract line 4 from line 3.**

5. **Enter the result in both columns.**

6. **Is the amount on line 5 less than the amount on line 2?**
   - [ ] No
   - [ ] Yes

   If yes, some of your IRA contributions are deductible. For details on deductible IRA contributions, see Form 8606.

7. **Multiply lines 6a and 6b by 30% (.30) (or by 35% (.35) in the column for the IRA of a person who is age 50 or older at the end of 2004). If the result is $10,000 or more, enter $10,000 ($5,500 if age 50 or older at the end of 2004) on line 7 for that column and go to line 8. Otherwise, go to line 7.**

8. **Enter your wages, and your spouse’s if filing jointly, and other earned income from Form 1040, minus any deductions on Form 1040, lines 36 and 32. Do not reduce wages by any loss from self-employment.**

9. **Enter additional IRA contributions made, or that will be made by April 15, 2006, for 2004 to your IRA on line 9a and to your spouse’s IRA on line 9b.**

10. **On line 10a, enter the smallest of line 7a, 8, or 9a. On line 10b, enter the smallest of line 7b, 8, or 9b. This is the most you can deduct. Add the amounts on lines 10a and 10b and enter the total on Form 1040, line 25. Or, if you want, you can deduct a smaller amount and treat the rest as a nondeductible contribution (see Form 8606).**
Refundable Child Credit – Form 8812

Form 8812

Instructions

Purpose of Form

Use Form 8812 to figure your additional child tax credit.
The additional child tax credit may give you a refund even if you do not owe any tax.

Who Should Use Form 8812

You can use Form 8812 if you: have allowed for the child tax credit on line 1 of Form 1040; or you are using Form 1040A; or you are using Form 1040EZ and have a refundable child tax credit.

Effect of Credit on Wages

You can use Form 8812 to claim the additional child tax credit on your next tax return. You can make your claim for the additional child tax credit even if you do not owe any tax.

Earned Income

The maximum amount of earned income that you can include on Form 8812 is $3,950. If you earn more than $3,950, you may be eligible for the additional child tax credit.

Taxable and Nontaxable Income

The maximum amount of the additional child tax credit is limited to $3,950. If you earn more than $3,950, your additional child tax credit may be reduced.

Railroad Employee

If you work for a railroad, include the railroad income on line 1 of Form 8812, line 10.

Paperwork Reduction Act

We ask for this information in order to carry out the internal revenue laws of the United States. You are required to give the information. We need the information to compute your tax.

You are required to file the information on a return that is subject to the Paperwork Reduction Act. The act requires that we conduct a study to determine the amount and nature of any new burden on you. Generally, the act requires that the burden be minimal and that the form be given to you in a reasonable amount of time.

If you believe that the time for filing a return is too short, you may apply for an extension of time to file. If you are not sure how to file your return, you may apply for an extension of time to file. If you apply for an extension of time to file, you must file Form 1040, line 10.
**Child Tax Credit Worksheet**

**Part 1**

1. Number of qualifying children: _________ × $1,000. Enter the result: ___

2. Enter the amount from Form 1040, line 37, or Form 1040A, line 22. ___

3. **1040 Filers.** Enter the total of any—
   - Exclusion of income from Puerto Rico, and
   - Amounts from Form 2555, lines 43 and 48; Form 2555-EZ, line 10, and Form 4563, line 15.
   - **1040A Filers.** Enter 0.

4. Add lines 2 and 3. Enter the total: ___

5. Enter the amount shown below for your filing status.
   - Married filing jointly - $11,000
   - Single, head of household, or qualifying widower(wer) - $7,500
   - Married filing separately - $5,500

6. Is the amount on line 4 more than the amount on line 5?
   - **No.** Leave line 6 blank. Enter 0 on line 7.
   - **Yes.** Subtract line 5 from line 4.

7. Multiply the amount on line 6 by 5% (0.05). Enter the result: ___

8. Is the amount on line 6 more than the amount on line 7?
   - **No.**
   - **Yes.** Subtract line 7 from line 1.

9. Enter the amount from Form 1040, line 45, or Form 1040A, line 28: ___

10. Add the amounts from—
    - Form 1040 or
    - Form 1040A
    - Line 60
    - Line 67
    - Line 68
    - Line 69
    - Line 70
    - Enter the total: ___

11. Are you claiming any of the following credits?
    - Adoption credit, Form 8839
    - Mortgage interest credit, Form 8396
    - District of Columbia first-time homeowner credit, Form 8859
    - **No.** Enter the amount from line 10.
    - **Yes.** Complete the Line 11 Worksheet on the next page to figure the amount to enter here.

12. Subtract line 11 from line 9. Enter the result: ___

13. Is the amount on line 8 of this worksheet more than the amount on line 12?
    - **No.** Enter the amount from line 8.
    - **Yes.** Enter the amount from line 12. See the TIP below.

**This is your child tax credit.**

**TIP**

You may be able to take the additional child tax credit on Form 1040, line 67, or Form 1040A, line 42, only if you answered "Yes" on line 13.

- First, complete your Form 1040 through line 66, or Form 1040A through line 41a.
- Then, use Form 8812 to figure any additional child tax credit.
Statutory Marginal Tax Rates

Tax Rate Schedule for Head of Household with 2 Children

<table>
<thead>
<tr>
<th>Taxable Income Less Standard Deduction and Personal Exemptions</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>0%</td>
</tr>
<tr>
<td>20,000</td>
<td>5%</td>
</tr>
<tr>
<td>40,000</td>
<td>10%</td>
</tr>
<tr>
<td>60,000</td>
<td>15%</td>
</tr>
<tr>
<td>80,000</td>
<td>20%</td>
</tr>
<tr>
<td>100,000</td>
<td>25%</td>
</tr>
<tr>
<td>120,000</td>
<td>30%</td>
</tr>
<tr>
<td>140,000</td>
<td>30%</td>
</tr>
</tbody>
</table>
Phase-Outs Increase Marginal Tax Rates

Marginal Federal Income Tax Rates for Hypothetical Head of Household with Two Children in 2005

Note: Calculations are for a head of household with two children under 17. Itemized deductions are assumed to be 18 percent of income.

Source: Department of the Treasury, Office of Tax Analysis
Instability of Current Code

- Frequent Amendments
  - 14,400 changes to the tax code since 1986.

- Expiring Provisions
  - Multiply compliance costs.
  - Create instability and make planning for the future geometrically more complicated.
  - Undermine faith in the tax system by causing annual unpleasant surprises.
## Selected Expiring Income Tax Provisions*

<table>
<thead>
<tr>
<th>Item (Expiration Date)</th>
<th>2005</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Tax Rates (2010)</td>
<td>10%</td>
<td>15%</td>
</tr>
<tr>
<td></td>
<td>15%</td>
<td>28%</td>
</tr>
<tr>
<td></td>
<td>25%</td>
<td>31%</td>
</tr>
<tr>
<td></td>
<td>28%</td>
<td>36%</td>
</tr>
<tr>
<td></td>
<td>33%</td>
<td>39.6%</td>
</tr>
<tr>
<td></td>
<td>35%</td>
<td></td>
</tr>
<tr>
<td>Marriage Penalty Relief (2010)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-15% bracket thresholds</td>
<td>200% of single amount</td>
<td>167% of single amount</td>
</tr>
<tr>
<td>-Standard deduction</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Child Credit (2010)</td>
<td>$1,000</td>
<td>$500</td>
</tr>
<tr>
<td>Tuition Deduction (2005)</td>
<td>$4,000/$2,000</td>
<td>Unavailable</td>
</tr>
<tr>
<td>IRA Contribution Limit (2010)</td>
<td>$4,000 ($4,500 if over 50)</td>
<td>$2,000</td>
</tr>
<tr>
<td>Dividends (2008)</td>
<td>5/15%</td>
<td>Ordinary rates</td>
</tr>
<tr>
<td>Capital Gains (2008)</td>
<td>5/15%</td>
<td>10/20%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>8/18% (if held over 5 years)</td>
</tr>
<tr>
<td>AMT Exemption (2005)</td>
<td>$58,000</td>
<td>$45,000</td>
</tr>
<tr>
<td>Small Business Expensing (2007)</td>
<td>$105,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

*Married filing joint
“Complexity Tax”

- Complexity is costing the U.S. economy $140 billion per year
  - Roughly the same as giving $1,000 to every family in America, or
  - The amount needed to fund: the Department of Homeland Security, the State Department, NASA, HUD, the EPA, the Department of Transportation, the United States Congress, our Federal courts, and all foreign aid

- Over 3.5 billion hours spent doing taxes
  - 25 hours on average -- more than half a work week
  - Like having almost 2 million extra IRS agents

- Over 60 percent of Americans use a paid preparer
  - 1.2 million paid tax preparers in 1999 (Twice the number of police officers and four times the number of firefighters)
  - Less than 13 percent of returns are still prepared by hand!
Transparency and Fairness

- Complexity --
  - Reduces the transparency of the tax system.
  - Rewards those who have the means and inclination to find all the angles.
  - Undermines trust in the fairness of the tax system, which may in turn undermine voluntary compliance.

- Taxpayers who play by the rules should be able to have confidence that they and their neighbors are all paying their fair share.

- The “Hazy Tax”
  - Additional amount paid by honest and careful taxpayers due to noncompliance and evasion of others.
  - In 2001, the Tax Gap was between $312 and $353 billion* (most recent IRS estimate).
  - Although factors other than complexity certainly play a role, a simpler tax code would improve compliance and reduce the gap.

*Includes $70 - $75 billion in employment and excise taxes.