Simple Filing for Average Citizens: The California ReadyReturn

By Joseph Bankman

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Polls consistently report widespread dissatisfaction with the income tax — dissatisfaction that is picked up (and in some cases amplified) by political leaders and commentators.1 The average citizen dislikes the tax not because it distorts or discourages investment (although it does), but because it is complicated, because she finds filing expensive, time consuming, and anxiety provoking, and because she believes that complexity (and other factors) allow others to avoid paying their fair share.2

The source of complexity for high-income taxpayers is obvious: They are apt to be engaged in business planning through the year and their year-end return is affected by the alternative minimum tax, savings incentives, various other deductions and phasewouts, the complicated rules governing stock options and vacation homes, and so on. What is less obvious, but no less true, is that the income tax is experienced as complex by those taxpayers who have only wage and interest income subject to third-party reporting, who do not itemize, and whose experience with the tax system is mostly confined to filing a return.3

In California, approximately 7 million (or about 40 percent) of all taxpayers fall into that category. The tax year starts for those individuals with the receipt, in the mail, of Forms W-2 and 1099. Those forms are hardly self-explanatory (look at one sometime). Next come the tax return forms. There is some evidence that IRS forms are better written than most government forms and that this group of taxpayers face some of the simplest of IRS forms (and state forms modeled after the IRS forms).4 However, for a substantial portion of the population, those forms are not at all simple. Slightly more than 20 percent of the population lacks the skills necessary to read a food label, fill out a form, or read a simple story to a child.5 Even individuals with terrific reading skills find filing an anxiety-laden experience. Some taxpayers react to the filing requirement like a deer caught in headlight and never file. Of course the task can be delegated, at a cost, to an adviser, but finding the right adviser raises other issues. When the return is finally sent out, the taxpayer still wonders if she has done everything right. Economists have attempted to measure the time spent on filing and fees paid by taxpayers but cannot measure the anxiety, frustration, and anger associated with filing.

The sad part of all of this is that it is largely unnecessary. The government already has the wage and interest data reported by the taxpayer. When the tax return is received by the state of California, it checks the taxpayer’s reported wages and interest against its own figures, and checks the taxpayer’s calculation of how that data translates into tax liability. If the state’s figures and the

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2Responses to polls are obviously affected by the questions asked, and how those questions are framed. The sources of dissatisfaction are numerous and no doubt include issues not enumerated above, most notably including the belief that the system is unfair in a manner unrelated to complexity. (Polls do not separate out the component of unfairness that is complexity-related.) That said, the statement that complexity-related issues are responsible for a large portion of dissatisfaction with the income tax is generally consistent with polling data and (I believe) the position of most tax professionals and scholars.

3Polls that ask taxpayers how complex the law is do not break down the results by the complexity of the return. However, an examination of one of the most complete recent polls shows that those with the least income (and presumably the least-complicated tax returns) still found the tax complex. For example, approximately 80 percent of those with annual income below $20,000 reported they found the tax system either very or somewhat complex; that figure rises to nearly 100 percent for taxpayers with incomes exceeding $150,000. (NPR Poll; Results available from the author.) Perhaps the best evidence for the proposition that complexity is a concern to those with simple returns is the enthusiasm with which those with the simplest returns embraced the ReadyReturn, discussed infra in this article.


taxpayer’s figures do not match, the state sends out a notice of deficiency. Why not have the government tell the taxpayer ahead of time what figures have been reported to it in the taxpayer’s name, and the tentative tax liability it believes those figures produce?

The California ReadyReturn Pilot Program

This past filing season the California Franchise Tax Board (FTB) set up a pilot program to do just that. The FTB sent out 50,000 pro forma returns, or ReadyReturns, to individuals who in 2003 did not itemize and had wage income only, and appeared to fall into that same category in 2004. The ReadyReturns stated the wage income reported to the state and the tentative tax liability produced by that wage income. Taxpayers could file the ReadyReturn as prepared, correct the ReadyReturn, use the ReadyReturn as a starting point for determining their tax liability, give the ReadyReturn to their preparer, or simply throw the document away. The option of using or correcting the ReadyReturn was also available online. (A copy of the mailing that accompanied the ReadyReturn can be found at http://www.taxreformpanel.gov/meetings/meeting-05172005.shtml.)

The ReadyReturn project was supported by $200,000 already allocated to the FTB. Virtually all of that was spent on start-up costs for programming and survey design. Future costs per return of a scaled-up program should consist primarily of postage and mailing, with some administrative costs for data collection, monitoring, and Web site maintenance. It is possible that much of the administrative cost of the ReadyReturn will be offset by a decrease in processing costs, due to both the increased likelihood of online filing and the decreased number of deficiency notices sent out to correct mathematical and input errors.

California grants automatic six-month extensions, so no-penalty filing will continue until at least October 15, and some ReadyReturns are still coming in. However, the bulk of participants in the pilot program have already filed and at this point it appears that between 15 percent and 20 percent of the participants will file the ReadyReturn. That is about what was predicted, both by the state and in an earlier Treasury Department study, which commissioned a poll that showed 17 percent would participate in the first year under a similar program, with 20 percent of the participants will file the ReadyReturn. It was limited as well by the fact (discussed below) that the program does not now cover federal returns.

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What was surprising is how popular the ReadyReturn was with those who used it. More than 98 percent of those who used the ReadyReturn said they would use it again. A large portion of those surveyed added comments to their survey answers: There were nearly a thousand comments in total. The responses are wildly enthusiastic: It is difficult to imagine any government program garnering such favorable responses. A sampling:

Ready Return is the best thing in the world. . . .
FANTASTIC service . . .
Wow! Government doing something to make our lives easier for a change. The Feds should take notice. Thank you California FTB.
This was wonderful. I hope you continue to offer this in the future. Please pass this comment on to the Governor. This is one of the best products offered by the State that saves time and money for the average Californian and makes tax paying a pleasant experience. Thank you [taxpayer signed his name here]
Please make it this easy to file federal taxes.
Thank you for choosing me for this pilot program. I love it. I hope I can file my federal return the same way next year.
This has made my life a lot easier. Thank you.
Thanks for making my file so much easier. I hope you keep this around forever. Whoever thought of this deserves a big fat raise.
THIS IS A GREAT PROGRAM AND ONE THAT EVERYONE SHOULD BE USING.
This is a great service from my government. I love the invite and wish the feds would do the same. Good work and thanks from this taxpayer. This is an awesome pilot program. . . .
Go Governor!

The few critical comments generally focused on flaws in the “beta” version of the ReadyReturn that can easily be fixed. For example, a number of respondents stated they were confused by the use of the term “PIN.”

The complete, unedited comments of the first survey can be found online at http://www.ftb.ca.gov/readyReturn/comments.html. Readers of this journal will find those comments the single most useful piece of information about the project. The comments from later

file online and receive a direct deposit of the refund within a few days. Early filers this year had no reason to expect a ReadyReturn (and only a handful of pilot program participants got a ReadyReturn) and therefore no reason to delay filing.
Data is still being collected on the ReadyReturn pilot; some evidence as to the effect of the program on tax revenue will be known by comparing the pilot participants with a matched set of nonparticipants. In all likelihood, the program will have a very small negative effect on revenue. The program is likely to increase filing rates; that may lead to increased cost in the short term (because many nonfilers have refunds coming) but increased revenue in later years.

What about evasion? The ReadyReturns were sent to taxpayers who reported only wage income in 2003 and who appear to have only wage income in 2004. It’s possible that some of the recipients of the ReadyReturn did not report additional sources of income in 2003 and, more significantly, had additional sources of income in 2004. The ReadyReturn will not include that form of income and will therefore understate tax liability. However, revenue loss from understatement should be small. First, ReadyReturn recipients are explicitly told they must include additional sources of revenue and at least some participants will no doubt do so. Second, and most importantly, income not subject to third-party reporting received by members of this group (for example, cash for odd jobs) is generally not reported to the state anyway. Finally, members of this group are in the lowest tax rates.

It is useful to think of the ReadyReturn like a Visa bill. Visa does not send its customers a blank piece of paper each month with instructions for the customer to write down all charges. Instead, it sends its customers a record of the transactions it has in its computer. Customers demand that, and not simply to save time and effort. Customers need to know what data the company has so they can check bills and avoid false charges.

Politics

The ReadyReturn pilot was supported by Steve Westly, the state controller and highest ranking Democratic official in whose bailiwick taxes fall. It was also supported by Republican Gov. Arnold Schwarzenegger’s finance directors, Donna Arduin and (currently) Tom Campbell. It is supported as well by a number of former officials from the Reagan, George H.W. Bush, and Clinton administrations, and by a wide variety of tax scholars and policymakers.

However, the program is opposed by the California Libertarian Party, Americans for Tax Reform, and similar groups. One of the most vocal opponents has been Grover Norquist, the founder of Americans for Tax Reform. Norquist is probably best known for his statement that he’d like to get government down “to the size where I can drag it into the bathroom and drown it in the bathtub.” Despite (or maybe because of) the extreme rhetoric, Norquist is one of Washington’s most powerful figures. He and his organization carry significant weight with conservative legislators and he has been referred to as the driving force behind the repeal of the estate tax.10

In testimony before the President’s Advisory Panel on Tax Reform and elsewhere, Norquist argued that the program raised privacy concerns; that the program would be used to hide the user’s true tax liability; and that the program, now voluntary, would eventually be made mandatory and expanded to encompass most returns.11

None of those objections has any merit. The ReadyReturn does not require the state to gather any new information and enhances privacy values by letting citizens know the information the state has already acquired. Nor will the ReadyReturn help hide the taxpayer’s true tax liability. The fact of the matter is that the current system does not provide much meaningful information about the tax system. Instead, it is largely an exercise in recordkeeping, reading comprehension, and math. Significantly, a substantial number of taxpayers even in the low-income subgroup give their return to paid preparers, thereby avoiding whatever knowledge would come from that exercise. The ReadyReturn could be used to increase the transparency of the system — simply by adding a statement that shows the taxpayer’s total tax paid, average tax rate and rate on the last dollar of income earned, and whatever additional information (for example, payroll taxes paid) is desired. Freed from the anxiety of completing the return, the taxpayer might actually be willing to read the provided information.

The FTB could expand the program to give other taxpayers access to information relevant to their return. For example, it could allow all taxpayers access to Forms 1099 issued in their name. The FTB could not, however, report tentative tax liability for individuals with more complex returns because that tax liability would depend on factors (for example, charitable contributions) not known to the government. The argument that the program would be made mandatory, therefore, is simply a scare tactic. The FTB has neither the plan, the incentive, nor (quite obviously) the political power or support to make the program mandatory.

Others, reflecting the same political perspective as Norquist, have argued that taxpayers will feel “obliged” to accept the state’s figures — an argument that is belied by the results of the pilot program. Most taxpayers decided to give the program a pass the first time around, and those that used the program raved about it.

There is something decidedly ironic about libertarians and others opposing a program that gives citizens access to information the state possesses and that gives taxpayers the choice of whether to use that information. One suspects that the opposition is based in part on the fear that the program will make citizens less angry at their taxes.
government, and less likely to support the particular set of reforms favored by that group.

The ReadyReturn is also opposed by companies in the tax preparation business, such as Intuit, the maker of TurboTax. The motivation of these companies is clear: They have a franchise to protect. One false argument that has been made by for-profit companies is that the ReadyReturn pits the government against private enterprise. In fact, the task of sending out ReadyReturns and maintaining a Web site for online filing could easily be contracted out to private enterprise via a competitive bidding process. The real question is whether taxpayers would find it useful to know the information that is in the government’s computer and whether that information could be made available at a reasonable cost. If (as the evidence shows) the answer is “yes,” the question of who provides the ReadyReturn can be decided on the basis of cost, security, and whatever other criteria seem appropriate.

While opponents of the ReadyReturn may have weak arguments, they have strong lobbyists, paid, in the case of Intuit and other companies, and paid and volunteer in the case of Americans for Tax Reform. In contrast, there has been little publicity about the program, and its strongest advocates — users in the pilot program — are few in number and are unlikely to know that the program is under attack. As a result, legislators and business groups hear only one side of the issue, and the future of the program at the state level is very much in doubt. On the other hand, if the project can be expanded to anywhere near the 2 million-7 million Californians potentially eligible, the responses to the pilot program suggest it will be enthusiastically supported by an army of users, and its future will be secure. (Of course, that prospect is not lost on the program’s opponents, who know they must kill the program now if they are to kill it at all.)

Extension to Federal Returns

The advantages to the California ReadyReturn, or any state-administered ReadyReturn, would obviously increase if the program covered federal returns. As long as federal returns are not included, many of the tasks of filing, such as recordkeeping, remain. Indeed, one of the surprising things about the pilot project is how grateful taxpayers were for the help on their California returns when they still had federal forms to deal with. A ReadyReturn-like system, referred to as an “agency reconciliation approach,” and return-free filing are discussed in a 2003 Treasury Department report. That report shows that the United States puts a higher filing burden on its low- and middle-income wage-earners than any other nation. A majority of developed nations have a return-free filing system for that group of their populations, with all taxes withheld at the source. Adoption of that system here would require significant structural change. We would need to adopt a flat tax on dividends and interest and place a greater burden on employees and employers to provide timely information on income and filing status. (To some extent, the W-4 becomes a tax return.) We would need somehow to enfold the earned income tax credit within the wage withholding system, or (more likely) find a separate body or mechanism to administer that credit.

Adoption of a ReadyReturn-type system would be easier. The major stumbling block is the lack of timely wage data at the federal (although not the state) level. That would cause difficulties not only for the IRS but for taxpayers as well. Returns would be sent out late, producing late refunds for taxpayers, most of whom in the low- and middle-income population would have funds coming.

The ReadyReturn pilot program, not yet up and running at the time the Treasury Department report was written, shows that (at the state level, at least) returns can be delivered to taxpayers in a cost-efficient and timely manner. More important, the pilot shows that a ReadyReturn-like program will be enthusiastically received by a considerable portion of the eligible population. One intriguing future possibility is that the federal government might set up a joint state-federal pilot program with California. The state could supply the IRS with wage data. As a service to its residents, the state might also provide the IRS with computer and other support. The residual costs of a pilot program would seem small in comparison to the upside of tens of millions of happier taxpayers. But for any of that to occur, the ReadyReturn program must first escape an untimely death at the hands of a few for-profit companies and its ideologically committed opponents.

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Tax Reform Cometh!

By Sheldon D. Pollack

Sheldon D. Pollack, Ph.D., J.D., is the director of the legal studies program at the University of Delaware. He is the author of *Refinancing America: Republican Antitax Policy* (State University of New York Press, 2003) and *The Failure of U.S. Tax Policy: Revenue and Politics* (Penn State Press, 1996). The following is the text of an imaginary speech to the President’s Advisory Panel on Federal Tax Reform. In his unsolicited (and sem facetious) testimony, Pollack chides those prophets of doom who predict that 1986-style tax reform is now impossible. He himself sees it coming right around the corner and suggests that policymakers in Washington go with the flow, rather than fight the imminent restructuring of the federal tax code. Anyway, he says, there is not much they can do about it. Tax reform cometh, like it or not!

Mr. Chairman and distinguished members of the panel:

Thank you for inviting me here to speak to you today about the possibilities for reforming the federal tax code. Tax reform is a truly noble endeavor — admittedly a notch below finding a cure for cancer or AIDS, but important nonetheless. While many of the experts who previously testified before you were highly pessimistic of the possibilities for future tax reform, and some have even been skeptical of the value of holding these public hearings, I offer you a more optimistic assessment. Indeed, my message is that tax reform is just around the corner, if only policymakers will shut up and let it happen. How will it come? How can I, the most cynical of academics, predict such a rosy future for the tax system?

I know it sounds improbable, but 1986-style tax reform cometh! I ask you to imagine the following scenario (or something similar to this) playing out in Washington, as I believe it will soon enough. Imagine that after a much-needed summer recess (not this summer, but some summer in the not-too-distant future), Congress returns to Washington strangely invigorated and emboldened. Maybe it’s because the Washington Nationals are in first place and the Redskins, defending Super Bowl champions, have just opened training camp, or maybe it’s just the cool and crisp weather that so often takes hold of Washington in mid-August. Whatever the reason, congressional policymakers are in great spirits and poised to take action. Instead of just responding to the latest proposal from the White House to reform Social Security or enact some new tax cut for the rich, they grab the bull by the horns and tackle the thorny issue of tax reform.

Impatient GOP insurgents in the House have long been pressuring their own leadership to pursue “fundamental tax reform” — really *fundamental* tax reform. Amazingly, a bipartisan coalition with support in both houses begins to coalesce around the issue. After weeks of political wrangling and logrolling, a major tax reform bill emerges from the Ways and Means Committee and is quickly ushered to the floor of the House, where it passes immediately. Then the Senate does the unthinkable: A bipartisan coalition votes to rip the income tax out by its roots and toss it overboard — presumably into the poisonous waters of the Potomac River. Not too surprisingly, President Schwarzenegger promises that he will sign the bill as soon as it reaches his desk!

Not being irresponsible, and knowing that the money for the president’s $1 trillion schnitzel-laden budget has to come from somewhere, Congress contemplates an alternative tax system. In place of the much-maligned old federal income tax, policymakers consider a flat tax, or something pretty close to one — a tax system with just two or three tax brackets and a minimally progressive rate structure. A generous exemption (around say, $45,000 for a married couple filing jointly) creates a zero-tax bracket to keep millions of low-income taxpayers off the tax rolls. The new tax is imposed at a very moderate rate (somewhere around 26 percent) on income above the zero bracket, and for those with the greatest income, there is a slightly higher tax bracket — just 2 percentage points above the basic bracket. That keeps all the GOP flat-taxers happy.

Liberal Democrats demand that the maximum marginal rate kick in at a fairly low level. That is resisted by Republicans, but in conference committee, they give in and the threshold for the maximum rate is set at a paltry $175,000. Even with that compromise, conservatives who have been pushing for a flat tax for the past two decades are thrilled about what is unfolding before their very eyes. Reading about the legislative initiative in his own magazine, publisher Steve Forbes is so excited that he can barely contain himself. He actually gets so giddy that he must be hospitalized for several days!

Further imagine the unthinkable. To induce liberal Democrats to give their tacit consent to the flat rate structure and refrain from filibustering the proposed tax legislation (assuming the filibuster has not yet been “nuked” by Senate Republicans), the GOP leadership agrees to several other major compromises in conference committee. First, the new Senate majority leader, the recently exhumed Strom Thurmond of South Carolina, announces that Republicans are finally willing to accept what economists at the Brookings Institution have been proposing for decades now — the elimination of all tax deductions and exemptions that depart from a pure economic determination of taxable income. Just as in 1986, when liberal Democrats pushing for a comprehensive tax base joined with supply-side conservatives seeking lower marginal rates, the new bipartisan coalition comes together behind an agenda for tax reform qua broadening the tax base. Republicans grudgingly agree to eliminate tax preferences to induce Democrats to support lower rates and the near-flat rate structure. The result is that Congress discards just about every deduction and exemption. Even the parsonage exemption falls to the ax of the tax reformers.

Pundits, academics, and journalists are rendered speechless (even Lee Sheppard) as Congress throws the income tax overboard and expunges all the countless ...
credits and exemptions enacted over the past five decades. Gone are age-old preferences for depletion, tax-exempt interest, interest on private activity bonds, farming, incentive stock, and the unearned income of children of the taxpayer. The personal exemption and miscellaneous deductions are phased out of existence, and no one sheds a tear. The standard deduction is axed. The deductions for property tax, state and local income taxes, and interest paid on a home equity loan are relegated to the dustbin of history. Alas, the sacred deduction for home mortgage interest is retained; however, tax reformers pledge to go after that sucker next session. (Who knows, maybe one day they will succeed.) What is left is as close to a comprehensive tax base as we have had since 1913. Prof. Boris Bittker cracks open a bottle of champagne to celebrate!

The new tax system is lean, mean, and virtually flat. It also is a much simpler tax code. Because it is simpler, it is deemed “fairer” — although no one can really explain why that is so. Members of both parties are thrilled, with Republicans and Democrats alike claiming credit for the successful tax reform campaign. (Perhaps the politicians are just imagining all the golden opportunities that lie ahead for reenacting all the tax preferences just repealed.)

The best part is that even if the new tax system comes up a bit short on what is needed to finance the current level of federal spending (which has doubled every two years during recent Republican administrations), there is no need to worry. In this historic omnibus tax legislation — the Flat and Comprehensive Omnibus Capital Tax Act (FACOCTA) — Congress also abandons those onerous provisions enacted back in 1981 that indexed the income tax brackets. Boy, that one turned out to be a drag! After provisions enacted back in 1981 that indexed the income tax brackets. (FACOCTA) — Congress also abandons those onerous deductions that used to bring in additional revenue for Congress to spend as inflation drove taxpayers into higher brackets. By not indexing the new semi-flat tax brackets, those thrilling stealth tax increases of yesteryear soon will be enjoyed once more. It’s only a matter of time before the cash starts flowing in. So drop the fed funds rate and bring on the inflation, Chairman Greenspan, and soon the budget will be balanced and the national debt erased!

Admittedly, there are a few downsides, although nothing the country can’t live with. Tax lawyers and accountants are rendered obsolete under the new highly simplified flat tax system, which requires only an annual postcard-size tax return. Most tax professionals elect early retirement under the recently reformed Social Security system, which pays proportionately greater benefits to those who once had big incomes but then lose their jobs. A few of those young enough to start over retool by developing expertise in more “socially useful” (read, in demand) areas of the law — things like elder care law (also known as Medicaid fraud counseling) and the new and highly exhilarating chapter 13 bankruptcy practice.

Fortunately, most tax academics, for whom there is even less demand without a complicated income tax, have tenure and get to keep their jobs. However, their law school deans force them to teach more valuable and demanding classes, such as legal ethics and professional responsibility. Sadly, muckraking journalists David Cay Johnston, Donald Barlett, and James Steele are laid off by their newspapers as there are no “special interest” provisions left in the tax code for them to expose. Paul Krugman limps back to Princeton after his gig with The New York Times ends. Bob McIntyre is forced to close the Washington offices of Citizens for Tax Justice because there is nothing left in the tax laws to outrage him. Perfect justice is achieved in the new tax code. The republic is secure!

The kind of tax reform that is imminent will come slowly, phased in over the next decade or so. What is the vehicle that will carry tax reform on its wings? Ironically, the much-despised AMT.

Sounds like fantasy, Mr. Chairman? Maybe, but it also is what the future heralds — sort of. Unless Congress takes some incredibly foolish action, which is always a possibility, eventually we will get something quite similar to the tax system described above. Sure, it won’t arrive in such a dramatic and exciting scenario. The kind of tax reform that is imminent will come slowly, phased in over the course of the next decade or so. What is the vehicle that will carry tax reform on its wings? Ironically, the much-despised alternative minimum tax will be the savior of the U.S. tax system. Of course, that is not what most experts are saying now, and it certainly is not what Congress had in mind when it originally dreamed up the precursor of the AMT in 1969.

Back then, the Senate Finance Committee approved a reform provision enacting a new minimum tax of 10 percent imposed on certain tax preferences. At first, the minimum tax took the form of an add-on tax, imposed in addition to the regular tax. What moved Congress to devise such a tax? Recall that, at the time, much was being made about how some wealthy families were abusing the system and weren’t paying any income tax. Rather than simply eliminate the abusive tax preferences that allowed those wealthy taxpayers to escape taxes, congressional policymakers wanted to have their pork and eat it too. So Congress created a new tax to mitigate the benefits of those preferences. That way, they could say to their constituents that they had “repealed” the offensive tax preferences, when really they had only limited the ability of the rich to completely avoid paying taxes.

But that new tax did not work very well, as it was still possible for wealthy taxpayers to avoid the tax collector. Later in 1982, the minimum tax was transformed into a second tax system parallel to the “regular” federal income tax regime — a kind of a bizarro tax world wherein deductions are not allowed, tax credits cannot be claimed, and tax cuts are not respected. The only thing missing is a bizarro commissioner and his sidekick, bizarro chief counsel. The new AMT permitted legislators to retain the preferences under the regular income tax (thereby avoiding offending their important constituents, who were the intended beneficiaries of the original tax
preferences in the first place), while simultaneously cultivating the illusion for public consumption that they were preventing “tax abuse” by disallowing the very same preferences under the AMT. That is a classic case of what political scientists refer to as “grandstanding.” Others call it trying to have it both ways. Whatever it is called, it does not make for good tax policy.

There was an opportunity to dump the AMT during the successful campaign for tax reform in 1986, but instead short-sighted policymakers actually raised the AMT tax rate and expanded the list of tax preferences to include such common and widespread “abuses” as the personal exemption, the exemption for dependents, and the standard deduction. That was considered tax reform back in 1986. The corporate AMT was also conjured up by tax reformers that same year.

What became of that magnificent failure of vision? Other than introducing greater complexity and incoherence into the income tax (especially for corporations subject to the corporate AMT), not much actually happened for a number of years. Most individual taxpayers continued to enjoy the panoply of deductions and exemptions still available under the regular income tax. Certainly the great American middle class avoided the new impost, as was intended. Sure, a few unlucky souls were snared by the AMT and forced to pay extra taxes, but most escaped its grasp. As recently as 1987, only 140,000 taxpayers paid AMT. Those were well-heeled taxpayers who made significant (dare I say, piggish) use of the “semirepealed” tax preferences — those preferences retained in the regular tax, but repealed under the AMT. Not many of us shed tears for those rich folk spared by the AMT. The hypocrisy of the whole thing was obvious, but so long as only a few piggies were skewered, everyone else looked the other way.

Well, I need not tell you that things have changed! You, the esteemed members of the president’s advisory panel, certainly know the rest of the story. Because the AMT was never indexed to prevent bracket creep, the relatively generous thresholds for that tax regime never kept pace with inflation. It was only a matter of time before ever greater numbers of taxpayers faced liabilities under the AMT. Compounding the problem, as Congress kept enacting new “tax preferences” (including seemingly innocuous items like the child tax credit and higher standard deductions), the AMT came into play for many taxpayers who claimed the new benefits. Then, in 2001 and 2003, the Bush administration got its way on tax cuts. The Bush tax cuts reduced marginal rates under the regular income tax, thereby further exposing the upper-middle class to the AMT. What the Bush administration giveth, the AMT taketh back. Those who thought they received tax cuts under the regular income tax now find themselves potentially losing those savings to the AMT.

Many of those now facing the AMT are surprised and shocked by the results. That is especially true of middle-class taxpayers who find themselves with an AMT liability. Also, a whole lot of folks who exercised stock options that declined in value in 2004 were pinched by the AMT, as the value of the options as of the date of exercise is taxed under the AMT (even while it is deferred under the regular tax). Similarly, anyone who collects a big legal settlement and tries to deduct their legal fees faces a potential AMT nightmare. (The regular income tax does not give a very fair result either, but that is another story.) The AMT is biting more and more taxpayers, and it is biting them harder and deeper. Ouch!

As soon as enough taxpayers began to get pinched, stories about the dreaded AMT started to appear in the lowbrow popular media — the prime-time television news magazine shows, the National Inquirer, and The New York Times. It was not long before the ears of representatives in Congress began to perk up as they heard their constituents squealing. The AMT soon became public enemy number one — or at least, political punching bag number one. Even IRS National Taxpayer Advocate Nina Olson jumped on the bandwagon, calling the AMT the “most serious problem faced by taxpayers” and a “time bomb on a short fuse.”

All the fussing got Congress interested. So now the politicians are wondering what to do about the AMT. But do they really want to repeal the AMT? The answer is that while they strongly profess to wanting to repeal the AMT, talk is cheap in Washington, and so far they haven’t done very much, and for good reason. Even one-year cures are hard to pass. Republicans denounce the AMT as a hidden tax increase, but because it is a revenue raiser, it
actually allows them to enact “regular” tax cuts. Don’t expect them to help. Democrats denounce the AMT, but they resist Republican efforts to provide even temporary fixes, portraying those efforts as more tax cuts for the wealthy. The liberal editors of The New York Times recently accused the Bush administration of retaining the AMT as part of some devious plot to provoke middle-class taxpayers into supporting the administration’s own tax reform proposals. Talk about paranoia!

**With so many denouncing the AMT in such breathless hyperbole, why does it still survive? The answer is that despite all the hoopla in the press and political speeches, there really is no AMT ‘crisis.’**

With so many denouncing the AMT in such breathless hyperbole, why does it still survive? The answer is that despite all the hoopla in the press and political speeches, there really is no AMT “crisis.” Crisis is a term that gets thrown around a lot in Washington. There is a Social Security crisis. There is a budget crisis. Not long ago, the Clinton administration tried to scare us into buying Hillary’s vision of healthcare reform with prophecies of a national “healthcare crisis.” Back then, it took only a few faxes circulated around Washington by my old pal, conservative strategist Bill Kristol, to show the absurdity of that claim. It’s time to do the same with the AMT prophecies of doom. There was no healthcare crisis in 1993 (although there was, and remains, an inefficient and overly expensive system of third-party payments and insurance, and the distribution of healthcare itself is shamefully unequal among the citizenry), and there is no AMT crisis now. The term “crisis” suggests a systemic failure and impending collapse. The tax system is not collapsing on account of the AMT — the AMT is preventing it from collapsing. The AMT is a revenue backstop to the regular income tax. It ain’t no “time bomb,” Nina.

Okay, what then is the AMT? Actually, it is the solution, not the problem! The AMT is bringing in billions of dollars to the Treasury and subsidizes the regular tax system. That is why it costs so much to repeal the AMT — it brings in so much money! According to our friends at the Tax Policy Center, the 10-year cost of repealing the AMT in 2005 would be $660 billion (assuming the 2001 tax cut expires as scheduled in 2010), and it would cost more than $1 trillion to repeal the AMT if the Bush tax cuts are extended. Most revealing, by 2008 it will be more expensive to repeal the regular income tax (and keep the AMT) than to repeal the AMT (and keep the regular income tax). Of course, that is precisely the reason why the same politicians who rail against the AMT do not repeal it. We simply can’t afford to repeal the AMT. And if we really thought about it, we would understand that we will be better off allowing the AMT juggernaut to continue unimpeded, eventually swallowing up and replacing the regular income tax with a better, “reformed” tax system — which will happen, if only we let it. If only Congress lets it.

Why should we accept our fate and let the AMT replace the regular income tax? It’s simple: The AMT is the better tax system. Remember, it was designed to prevent taxpayers from abusing the tax code by claiming unwarranted tax preferences. Aren’t tax experts saying all the time that Congress should repeal those tax preferences? They can’t because of political pressures, but the AMT will do it for them. So let it happen!

What is so great about the AMT? It eliminates most tax preferences. It keeps things simple. It keeps rates low — precisely because it is imposed on a comprehensive tax base. It is close to flat. Sure, that pleases conservative Republicans more than liberal Democrats. But Democrats can’t have it both ways. On the Democratic National Committee Web site, Democrats complain that the AMT is a “secret” tool being used by Republicans to achieve a “regressive” flat tax — a preposterous claim because even a truly flat tax is not “regressive” by definition. That also is a convenient distortion of their own role in the historical origins of the AMT, as well as a serious misreading of how efforts for tax reform succeeded in 1986. Back in 1986, liberal Democrats willingly compromised with supply-siders and accepted lower marginal rates to secure the elimination of tax preferences. That made the reformer income tax flatter and allowed for lower marginal rates. So too ought liberal Democrats now accept the semiflat rate structure of the AMT in exchange for its comprehensive tax base. And of course, Democrats in Congress can always work later to eliminate those preferences still preserved by the AMT — for instance, the home mortgage deduction.

Democrats also shed crocodile tears because the AMT is hitting upper-middle-class taxpayers. They make it sound like some kind of scandal that the wealthy are not paying the AMT. How disingenuous can you get? The reason the rich don’t pay the AMT is because they are paying more under the regular income tax! Oh, I am sure the Bush administration would cooperate and lower the maximum marginal income tax rates further to expose the super-rich to the AMT, but somehow I suspect that Democrats would not be so pleased with that either. Nevertheless, Democrats are correct that the wealthy should be brought under the AMT regime. Indeed, the regular income tax should be phased out to bring them into the AMT party.

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Once the AMT surpasses the regular income tax as a source of revenue, it becomes politically feasible to repeal the old income tax regime. Inflation alone will never bring the rich under the AMT, and so the last 30 percent of taxpayers still under the old regime will need a push. In a revenue-neutral bill, the regular income tax could be repealed and an extra tax bracket or two added to the AMT for the newly arriving rich guys. The result would be an AMT with four or five tax brackets. Tax rates would
include the current three (zero, 26 percent, and 28 percent), and the new brackets could be something on the order of 30 percent and 33 percent — whatever would be necessary to preserve the current tax distribution. (Interestingly enough, that would bring back tax rates for individuals similar to those established by the Tax Reform Act of 1986.) Creating two new AMT tax brackets for the wealthy in legislation that is revenue and distribution neutral shouldn’t take too much political will!

Despite all the dire warnings and prognostications of doom and crisis, there really is very little political will in Washington for any fight over the AMT. In a wonderfully perceptive piece a few weeks ago in that most excellent journal, Tax Notes, analyst Joseph Thorndike rightly pooh-poohed all the hype and predictions of an imminent political train wreck over the AMT (April 11, p. 245). Joe was right when he predicted that the AMT will be the nation’s “next great nondisaster.” I recommend his piece to the members of this panel. But I go one step further than Joe. Not only will there be no political movement to repeal the AMT, but there shouldn’t be. As the AMT gradually replaces the income tax, the federal tax system will be strengthened. We should welcome this!

What will be left when the AMT replaces the regular income tax? Just one tax system that meets the criteria of tax reform agreed to during the historic compromise of 1986. No tax preferences, a comprehensive tax base, and lower marginal rates all achieved without the need for major and dramatic political action. That beats all the other tax reform proposals floating around. For example, Prof. Michael Graetz of Yale Law School (who always has good ideas) suggests that we repeal the regular income tax for lower- and middle-income taxpayers and keep either the current income tax or the AMT for the wealthy only. He also proposes a value added tax of 10 percent to 14 percent to make up the lost revenue. That is actually a fairly sound proposal on paper, but unfortunately it is one that Republicans will surely reject — and remember, they do control both houses of Congress and the White House. Republicans are looking to get rid of entire tax systems, not add new ones. The last thing they want is an income tax, the AMT, and a new VAT. On the other hand, doing nothing and allowing the AMT to phase in and replace the income tax will do the trick and actually is feasible politically. In Washington, doing nothing is always politically feasible.

So that is my recommendation to the president’s advisory panel: Tell both the president and Congress to relax and let tax reform cometh. Policymakers should do nothing. The AMT is our friend, and we should learn to love it.

Thank you for your kind attention and for inviting me to speak to you today!

Circular 230: A ‘Clarification’ That Muddies the Waters

By Kip Dellinger

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On May 19, 2005, the Treasury Department released final regulations revising the regulations governing practice before the IRS. The purpose of those regulations was to clarify the standards for covered opinions by taking into consideration perhaps a hundred pounds of comment letters from affected parties and professional organizations representing them that were submitted following the December 2003 proposed regulations and the subsequent (prospective) final regulations issued in December 2004.

After reviewing the clarifying revisions, I believe the regulations not only failed to clarify a most important aspect of the covered opinion standards but actually made at least that one aspect of the opinion standards considerably murkier for the vast majority of tax professionals — the sole, small-firm, and local-firm CPA practitioners — that advise their clients on everyday tax issues. Specifically, the structure and framework of the recent revisions make it all the more difficult to determine whether certain written advice will be construed by the IRS to be a “reliance opinion” (within the covered opinion regime). If so, when the opinion does not reach a “more likely than not” conclusion on a significant federal tax issue, the opinion must prominently disclose that it may not be relied on by the taxpayer for penalty protection.

In effect, the reader is left wondering if anything but the most insignificant advice arising from the most common everyday transaction will fall outside the purview of the “reliance opinion” provision of the revisions, thus qualifying as penalty protection advice under the “substantial authority” exception to the accuracy-related penalty assessable under section 6662(d). Moreover, because the final regulations under Circular 230 apply to any federal tax, as suggested by other writers, just about

1The new regulations appear to target those tax professionals that provide transactional tax advice (primarily tax lawyers and members of the tax practices of only the very largest CPA firms). However, Circular 230 (which encompasses the new regulations) applies to every person authorized to “practice before the Internal Revenue Service.” In that respect, I would suggest that the overwhelming amount of formal and informal (including email) written advice that is given to clients-taxpayers is given by CPAs in sole practice or as members of local or regional CPA firms. That includes a significant volume of advice that would be relied on for protection from assessment of the taxpayer accuracy-related penalty of section 6662.