CATO
BRIEFING
PAPER
April 13, 2023 Number 151

Four Ways to Simplify Taxpaying

By Adam N. Michel

This tax season, the IRS expects to receive more than 168 million individual tax returns, which will take Americans at least 2 billion collective hours to complete.[1] Often to the exclusion of smaller reforms, policymakers and economists tend to focus on the effects of things such as marginal tax rates or the value of tax subsidies for families. Unfortunately, that discussion can miss how immensely complicated and confusing the tax code is, especially for people with special circumstances, such as lower-income families with kids and education expenses.

Politicians on both sides of the aisle often get carried away with designing new or expanded tax programs without considering what is already in the tax code and how the whole system works when families file their taxes. As a result, the United States has at least 6 different sets of rules on how a child might qualify a family for tax benefits, more than 15 distinct tax programs targeted at higher education, 18 different tax-advantaged savings accounts, and 14 different deductions for people who itemize. The task of merely describing how these tax programs work is the subject of hundreds of pages of IRS instructions and countless inscrutable forms and worksheets. The more than 2 billion hours individual taxpayers spend complying with all these rules is equivalent to a cost of about $74 billion annually.[2]

The tax code's complexity has motivated reformers to propose wholesale rewrites of the federal tax system.[3] For example, a single-rate flat tax would dramatically simplify taxpaying, allow Congress to eliminate many of the most egregious tax preferences, and have significant economic benefits.[4] However, short of remaking the entire tax system, simple changes could help streamline some of the most complicated sections of the individual tax code and allow Congress to lower tax rates with the savings. The following sections describe the complexity of the tax code and propose modest reforms to streamline child-related tax benefits, education subsidies, retirement and other savings accounts, and itemized deductions.

On their own, the rules and structure of each of the following provisions are designed for a specific policy goal or political constituency. However, when layered one on top of another, each of these areas illustrates a problem with using the tax code to subsidize one activity over another—it often ends up being an incoherent mess that complicates a system designed to raise revenue, not meet myriad social goals.

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HARMONIZE DEFINITIONS FOR CHILD AND DEPENDENT BENEFITS

There are at least six different sets of rules for how a child might qualify their guardian for tax benefits through the larger head-of-household deduction, child tax credit (CTC), credit for other dependents, earned-income tax credit (EITC), child and dependent care tax credit, and dependent care flexible spending accounts. Table 1 describes some of the key features of each of these tax benefits.

Across the six child tax benefits, eligibility requirements differ by age thresholds, Social Security number requirements, child residency and support requirements, and definitions of earned income. For example, for a taxpayer to claim the larger parent EITC, their child must be younger than 19 (or younger than 24 if a full-time student); to claim the CTC, their child must be younger than 17; the credit for other dependents has no age limit; and to claim the child and dependent care tax credit or use a dependent care flexible spending account, their child must be younger than 13. A qualifying child does not have to be the taxpayer's dependent or meet support requirements for the EITC but must do so for the CTC, and the parent claiming the child does not need a work-valid Social Security number for the CTC but does need one for the EITC. To qualify for the EITC, a taxpayer's adjusted gross income must be below a certain threshold, but the refundable CTC uses *modified* adjusted gross income to determine eligibility—a definition of income that is not a line on the tax return.

Eligibility criteria for each tax benefit may have a specific rationale, but when combined across six different provisions, the system loses its coherence, leading to unnecessary taxpayer errors and confusion. The complexity of the EITC and refundable CTC alone results in tens of billions of dollars in filing errors each year. In 2020, 24 percent of EITC returns ($16 billion) resulted in improper payments to individuals not entitled to the credit. Twelve percent of refundable CTC payments ($4.5 billion) were improper.[5] A majority of erroneous EITC and refundable CTC claims had an issue with incorrectly reported income, but more than one-quarter were selected for audit due to other issues. According to the Treasury Inspector General for Tax Administration, a "significant number" involved multiple uses of the same child and confusion over other eligibility rules.[6] These errors are not always overpayment of refundable credits; often they also result in underpayments.

There are many ways to go about reforming these provisions. The most straightforward reform would eliminate each of the subsidies, many of which have economic and budgetary costs beyond the added tax filing complexity.[7] However, given the programs' political popularity, Congress could also consider more-extensive structural reforms that consolidate the various child-related tax subsidies while limiting their total value—or at least not expanding them.

Table 1
Tax subsidies for children

Name	Credit, deduction, or exclusion	Phase out
Child tax credit	$2,000 credit, refundable up to $1,500	Begins at: $200,000 (single) $400,000 (married filing jointly)
Credit for other dependents	$500 credit, not refundable	Begins at: $200,000 (single) $400,000 (married filing jointly)
Child and dependent care tax credit	20%–35% of $3,000 of qualifying expenses ($6,000 for 2 children)	Credit rate reduced from 35% to 20% between $15,000 and $43,000
Dependent care flexible spending accounts	$5,000 of qualifying expenses excluded from taxable income	None
Head-of-household status	Larger head-of-household standard deduction	None
Earned-income tax credit	$3,733–$6,935 refundable credit, depending on number of children	Maximum income from $43,492 to $59,187 depending on filing status and number of children

Sources: *VITA/TCE Volunteer Resource Guide—Volunteer Income Tax Assistance (VITA) / Tax Counseling for the Elderly (TCE)—2022 RETURNS*, publication 4012 (Washington: Internal Revenue Service); and Consolidated Appropriations Act, H.R. 2617, 117th Cong. (2021–2022).
Note: A smaller $600 earned-income tax credit is also available for single taxpayers without children and with lower maximum adjusted gross income of $16,480. The refundable portion of the child tax credit is the alternative child tax credit. Values are for tax year 2022.

Short of more comprehensive reforms, simply aligning common eligibility requirements across the different provisions would go a long way to simplifying the tax code. Congress could create single definitions for "qualifying child" and "qualifying dependent" that would make eligibility requirements consistent for each child and dependent tax benefit. Congress could institute consistent identification requirements—such as a work-eligible Social Security number for taxpayers and dependents—and one definition of earned income to claim tax benefits. For example, the EITC and CTC could both use adjusted gross income and define a qualifying child as a relative who is younger than 19, lives with the taxpayer for more than half the year, does not provide more than half their own support, and has a work-eligible Social Security number. Tiebreaker rules when multiple relatives claim the same child on different returns could also be simplified.

CONSOLIDATE EDUCATION CREDITS

The tax code includes at least 15 programs that subsidize and distort the education system and complicate tax filing.[8] The tax preferences have likely contributed to the high price of college as subsidies tend to increase demand, which in turn drives up prices.[9] This cycle contributes to inefficiently high levels of spending on education, significant student debt burdens, and ultimately demand for additional government subsidies.

Ten of the explicit tax subsidies for higher education are estimated by the Treasury to lower federal revenue by $322 billion over 10 years (2023–2032). Table 2 summarizes

Table 2

Tax subsidies for higher education

Name	Credit, deduction, or exclusion	Beginning of phase out
American opportunity tax credit	$2,500 credit per student, refundable up to $1,000; can only claim four times	$80,000 (single) $160,000 (married filing jointly)
Lifetime learning credit	$2,000 credit per return; not refundable	$80,000 (single) $160,000 (married filing jointly)
Credit for other dependents	$500 credit for other dependents	$200,000 (single) $400,000 (married filing jointly)
Head-of-household status	Larger head-of-household deduction for full-time dependent student younger than 24	None
Earned-income tax credit	$3,733–$6,935 refundable credit, depending on number of full-time-student children younger than 24	Maximum income from $43,492 to $59,187 depending on filing status and number of children
Student loan interest deduction	Deduct up to $2,500 in interest paid on qualified loans	$70,000 (single) $145,000 (married filing jointly)
Exclusion of canceled debt from income	Certain canceled student loans not included in taxable income	None
Scholarships, fellowships, and grants	Qualifying awards excluded from income	None
Employer-provided educational assistance	$5,250 of employer-provided assistance excluded from income	None
Business deduction for work-related education	Can deduct expenses to improve job skills	None
Coverdell education savings account	$2,000 annual contribution per beneficiary; earnings excluded from income	$95,000 (single) $190,000 (married filing jointly)
529 plan	Earnings excluded from income	None
Education exception on early IRA distributions	No 10% penalty on early distribution	None
Student loan payments can qualify for 401(k) matching contributions	Payments made on student loans treated like retirement contributions for employer matching	None
Education savings bond program	Interest excluded from income	$85,800 (single) $128,650 (married filing jointly)

Sources: *VITA/TCE Volunteer Resource Guide—Volunteer Income Tax Assistance (VITA) / Tax Counseling for the Elderly (TCE)—2022 RETURNS*, publication 4012 (Washington: Internal Revenue Service); and Consolidated Appropriations Act, H.R. 2617, 117th Cong. (2021–2022).

Note: Values are for tax year 2022; 401(k) student loan rule effective tax year 2023.

the 10 education tax programs Congress should repeal or reform to simplify the tax code. The remaining five programs lower taxes on education savings. These savings incentives should be expanded and they are addressed in the next section.

The American opportunity tax credit (AOTC) and lifetime learning credit (LLC) are the two biggest tax subsidies for college, providing a $2,500 and $2,000 tax credit, respectively. The AOTC can only be claimed four times, and the two credits cannot be claimed simultaneously. They also have different definitions of qualified education expenses and have separate eligibility criteria.

The complexities of these two programs create an environment in which more than 3.6 million taxpayers "received more than $5.6 billion in potentially erroneous education credits" in 2012, according to the Inspector General for Tax Administration.[10] Despite changes to the law and enforcement since 2012, the AOTC improper payment rate was 26 percent in 2020, higher than the improper payment rates for the EITC and the CTC.[11] Although some of these payments may be outright fraud, the majority are likely due to taxpayers' confusion about the rules and necessary documentation.

The tax code also includes a larger standard deduction, and a larger EITC for some taxpayers who claim a full-time student up to the age of 24. In addition, the system includes a deduction for student loan interest, benefits for student loan forgiveness, and exclusions for certain higher-education-related nonwage compensation.

Policymakers who are concerned that the tax code penalizes investment sometimes favor write-offs for education expenses, just as businesses write off equipment expenses. This is part of the rationale behind the business deduction for work-related education expenses and a similar individual deduction that was previously available. However, today's higher education is not just an investment; it also includes status signaling and consumption—intellectual consumption, as well as campus amenities.[12] Given all the other ways the government subsidizes education—for instance, in 2020 the federal government directly spent almost $30 billion on degree-granting postsecondary institutions—the cleanest answer is to remove the tax code from the education system.[13]

Short of repeal, simple changes would make complying with our education tax laws more straightforward. The AOTC, lifetime learning credit, student loan interest deduction, and benefits for full-time students younger than 24 could be consolidated into a single nonrefundable credit with one set of rules that is simple and easy to follow. The credit could be 25 percent of up to $10,000 of current-law lifetime learning credit expenses plus student loan interest with current-law income limits. House Republicans proposed a similar single education credit as part of the 2017 reforms, but it kept some of the complexity by maintaining time limits and changing rules in the fifth year of the expanded credit.[14] If Congress is going to provide subsidies through the tax code, it should strive for a simple, coherent system.

SIMPLIFY SAVINGS PROGRAMS

The tax code double taxes many forms of saving and investment. Wages are taxed when earned, and then if invested, any gains are taxed again as capital gains or dividends. This system taxes savers at higher marginal effective rates than those who spend their income immediately.[15] Special-purpose savings accounts, such as 401(k)s, individual retirement accounts (IRAs), and 529 plans for education, help alleviate some of the tax code's bias against saving. The education subsidy from 529 plans is not the exemption of earnings from being taxed; it is the rules restricting the funds only to education. These special-purpose savings accounts are only necessary under the current system that taxes investment returns multiple times. There is no need for special accounts under a well-designed consumed income tax that treats all consumption and investment decisions similarly—this should ultimately be Congress's goal.

In the current tax code, there are at least 18 different types of private retirement and education savings accounts, each with its own eligibility rules, income and contribution thresholds, early withdrawal penalties, and employer requirements. The patchwork of rules and limits that vary between even the most common plans discourages saving. Some of these accounts include the traditional IRA, Roth IRA, simplified employee pension plan, SIMPLE (savings incentive match plan for employees) IRA, 401(k), SIMPLE 401(k), 403(b), 457 plan, 529 plan, and Coverdell education savings account.[16]

Retirement savings is one of the most complex areas of tax law, and Congress keeps making it more complicated. The most recent two pieces of retirement legislation—the SECURE (Setting Every Community Up for Retirement Enhancement) Act and the SECURE 2.0 Act—introduced multiple changes

that ultimately made retirement savings policy more complicated by adding additional special rules and plan requirements, among other reforms.[17] Rather than continuously layering new rules on a broken system, Congress should eliminate the multiple sets of rules that govern each of these different retirement accounts in favor of a more streamlined system.

The system for retirement savings could be simplified by consolidating it into two types of accounts: an employment-based retirement account and an IRA. The contribution limits on both accounts should be the same, be at current 401(k) levels or higher, remove income limits on contributions, and maintain the option for Roth or traditional treatment. Required minimum distributions should be repealed so that retirees do not need to start drawing down their retirement accounts on a government-imposed timetable.[18]

Congress should also create a universal savings account that operates like a retirement account—income saved in the account would only be taxed once—but without restrictions on when funds can be spent or on what.[19] Without any withdrawal restrictions, taxpayers, instead of politicians, would get to decide how to spend their savings. A similar reform proposed in President George W. Bush's fiscal year 2005 budget would have consolidated the existing retirement system into two types of retirement accounts and created a universal savings account, called a lifetime savings account, that would have "allow[ed] an individual to earn a tax-free return on deposit amounts and withdraw the funds as needed without paying further taxes and without facing a withdrawal penalty."[20]

ELIMINATE ITEMIZED DEDUCTIONS

The tax code offers taxpayers the choice of taking the standard deduction or the sum of a list of 14 itemized deductions for specific expenses, such as mortgage interest, state and local taxes, and charitable giving. In 2020, 15.5 million households (9.5 percent) itemized their taxes, and millions more fell just below the cutoff, forcing them to keep records and add up their deductions to see if they would benefit from the special system.[21] These deductions can lower taxes significantly for some higher-income taxpayers, and Congress should use any increased revenue from repealing them to lower top-marginal tax rates.

Despite strong political constituencies favoring them, most itemized deductions are poorly targeted to meet their policy goals. For example, the state and local tax deduction tends to subsidize higher-income taxpayers in higher-tax states rather than support the provision of state services.[22] The mortgage interest deduction is not associated with additional homeownership. Instead, it tends to subsidize larger houses for older, higher-income taxpayers.[23] If policymakers decide that a specific deduction rises to the level of being important enough to retain, it could be moved "above the line," meaning it could be made a generally available deduction to all taxpayers. Moving too many deductions above the line would decrease the benefits of simplification, as it would require all taxpayers (rather than just the 9.5 percent who itemize) to follow the eligibility guidelines and maintain documentation.

By doubling the standard deduction and curtailing the value of some itemized deductions in 2017, Congress moved more than 29 million taxpayers from the more complicated itemized system to the standard deduction, saving taxpayers about 100 million hours of time that they would have spent filing their tax returns.[24] Congress should finish the job by eliminating itemized deductions for all taxpayers and lowering tax rates with the additional revenue.

CONCLUSION

This tax season, most Americans will use software or a paid preparer to file their taxes; they will answer a list of questions that a program uses to determine eligibility for dozens of different tax benefits. The process is a black box: information in, tax refund out. But policymakers should strive to design a tax system in which Americans can more easily understand what they owe in taxes and why. It has become a trope to say that the U.S. tax code is complicated, but often reform proposals focus first on big-picture, structural changes to the exclusion of smaller reforms that could also make taxpaying easier. Simplicity is only one of many important goals in designing a tax system, but it should not be neglected.

The U.S. tax code is too complex, and structural reforms are needed. However, short of a once-in-a-generation reform, there are several relatively simple ways to streamline the tax code that could make taxpaying easier for tens of millions of Americans. Congress should streamline definitions and eligibility criteria for child and dependent benefits, consolidate education tax subsidies, simplify the taxation of savings, and repeal itemized deductions.

NOTES

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14. An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act), H.R. 1, 115th Cong., 1st Sess. (as introduced in the House, November 2, 2017).

15. Adam N. Michel, "Universal Savings Accounts Can Help All Americans Build Savings," Heritage Foundation Backgrounder no. 3370, December 4, 2018.

16. The other eight are SARSEP (salary reduction simplified employee pension) plans, payroll-deduction individual retirement accounts, profit-sharing plans, defined benefit plans, money purchase plans, employee stock ownership plans, governmental plans, and multiple employer plans. "Types of Retirement Plans," Internal Revenue Service, last updated May 17, 2022.

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