

# Complexity, Compliance, and Communication

Why Should Taxpayers  
Comply in a Complex and  
Changing Tax Environment?

Nina E. Olson  
National Taxpayer Advocate

Presentation to the President's Advisory  
Panel on Federal Tax Reform  
March 3, 2005

# TY 2002 Taxpayer Characteristics

Median AGI	\$28,281
Median Wages	\$27,396
Median Schedule C	\$2,980
Median Schedule F	(\$3,436)
Filing Status	
Married/Joint	40%
Married/Separate	2%
Single	44%
Head of Household	14%

Note: The “mean” is the average (that is, the sum of numbers on a list divided by the number of numbers on the list). The “median” is the midpoint of numbers on a list (that is, half of the numbers are less than the median and half are greater than the median).

*{NTA - Federal Tax Reform - Notes for Slide 2}*

In my 2004 Annual Report to Congress, of which there are copies for you in the green room, I reported that the number one most serious problem facing taxpayers is the ***Confounding Complexity of the Tax Code***.

This complexity imposes enormous and unacceptable burdens on taxpayers.

I'd like to illustrate this point by presenting a taxpayer-centric viewpoint -

These statistics depict taxpayer characteristics. Each of these statistics represents the average value within its category. The "average" taxpayer is not necessarily represented by the statistic in each of the categories.

What leaps out immediately is that the "middle of the road" taxpayer is not affluent.

# TY 2002 Taxpayer Characteristics

	% of Returns	Num/Amt
Median number of Children	36%	2
Deductions		
Median standard deduction	64%	\$4,700
Median itemized deduction	36%	\$14,450
Retirement Deductions		
Mean IRA	3%	\$2,887
Mean Keogh	1%	\$13,775
Median Refund	80%	\$1,274
Returns Paid in Full	15%	\$803
Unpaid balance due returns	5%	-

*{NTA - Federal Tax Reform - Notes for Slide 3}*

We also see that 80% of returns result in a refund, that 15% of returns with a balance due are paid at time of filing, and only 5% of returns are unpaid at time of filing. We are talking about a population that is largely compliant.

Background statistics and information:

Rural Population	21%
Urban Population	79%
Median Child Tax Credit	\$600
Median EITC	\$1,746
Median Dependent Care Credit	\$480

# Projections for 2010

- Married couples with children = 22% of households, down from 31% in 1980.
- Taxpayers living alone, non-relatives living together, and families of non-married relatives = 49.6%, up from 39.1% in 1980.
- U.S. foreign-born and immigrant population = 11.3% (34 million), up from 10.4% (28.4 million) in 2000.
  - 51% of the foreign born will be from Latin America, 26% from Asia. 13% will speak Spanish in their homes.

*{NTA - Federal Tax Reform - Notes for Slide 4}*

These statistics are projections to year 2010. These projections are important since they are related to the ability of taxpayers to understand the complex tax code, and the ability of the tax code to reflect the life circumstances of its taxpayers.

Notably, it is projected that almost half of taxpayers will be living alone, non-relatives living together, and families of non-relatives

# Projections for 2010

- Households without children under 18 and non-family households will rely primarily on conventional methods of contact (non-Internet). This population includes elderly with restricted income or mobility.
  - Internet use will be lowest among people (1) over 50; (2) with incomes below \$35,000; (3) with high school or lower education levels; and (4) in non-family households.
- 157.7 million people will be in the workforce, up from 141 million in 2000.
- People age 55 and older = 17% of the labor force, compared to 13% in 2000.



*{NTA - Federal Tax Reform - Notes for Slide 5}*

Keeping in mind the average characteristics of taxpayers –

- Family status
- Foreign born
- Age of workers
- Internet usage – or not!
- Single or with non-traditional households (50% by 2010!)
- Median AGI

Here are a few areas of complexity for these taxpayers (although some of these provisions impact other types of taxpayers).

(next slide)

# Areas of Significant Complexity

- Earned Income Tax Credit (EITC).
- Alternative Minimum Tax (AMT).
- Retirement Provisions.
- Education Provisions.
- “Kiddie” Tax.
- Worker Classification.
- Family Status Provisions – dependents, filing status, child tax credit, dependent care credit.
- Electronic Commerce.
- Joint and Several Liability (including community property).
- Mortgage Interest Rules.

*{NTA - Federal Tax Reform - Notes for Slide 6}*

I'll talk about a few in a little more detail but ... regarding family status –

We've achieved some simplifications by enacting a uniform definition of a qualifying child – but we need the next step –

- Do we need all of these provisions?
- Must they be separate provisions?
- Do they reflect how taxpayers think about and live their lives?
- Are we focusing on characteristics that bear no relation to taxpayers' lives?
- How do we define a family unit if by 2010 almost half are single or non-traditional households?

# Complexity - EITC

- Provision contains 2,680 words and 13 subsections.
  - Requires at least a twelfth-grade education to understand.
- EITC Information Package (IRS Pub. 596) contains 53 pages of forms, instructions and worksheets.
- In TY 2003, 71.5% of EITC claimants used a paid preparer.
- The EITC overclaim rate is estimated to be 27% - \$8.5 billion of the estimated \$31.3 billion in 1999 EITC claims.

*{NTA - Federal Tax Reform - Notes for Slide 7}*

Finally, how do we “touch” people? Not just in the post-filing exam or collection environment, but also – how many hoops do we make taxpayers jump through to simply file their returns correctly?

From the Roper study we know that:

“The most heavily relied upon source of tax information and advice are IRS representatives (83% see them as very/somewhat valuable), closely followed by IRS printed publications such as brochures (82%), and the IRS website(77%). The only non-IRS-provided information source that is rated as highly is a paid tax professional (83%). RoperASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitude, September 2003, on page 17.

We also know from a 2004 study by Pew:

"When it comes to matters that may involve the disclosure of personal information, people feel comfortable with the phone or another means, with the Internet not widely being preferred by respondents. This is especially true for personal tax issues, where only one in six respondents said that they would turn to the Internet." The related stats show that 51% of the respondents felt more comfortable disclosing personal information over the phone, 17% on the Internet and 26% "some other way."

Pew Internet & American Life Project, How Americans Get in Touch With Government (May 24, 2004), page 22.

If the law is complex – or the taxpayer’s affairs are complex – they want to talk with the IRS. The internet is not going to help – taxpayers need to engage in a conversation to get to the right answer. And taxes are the most personal of information.

UK – use of applied and cognitive research and testing.

# Complexity - AMT

- Penalizes taxpayers for such “classic tax avoidance behavior” as having children or living in a high-tax state.
- In 2004, average AMT taxpayer is projected to owe additional \$6,000 in AMT (TPC estimate).
- Complexity impacts many more taxpayers than those who owe the AMT.
  - To determine whether AMT liability exists, taxpayers must complete 12-line worksheet, read 8 pages of instructions, and complete 55-line form.
- Adds insult to injury by subjecting many taxpayers to penalties.

*{NTA - Federal Tax Reform - Notes for Slide 8}*

The AMT, originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions, has morphed into a second layer of taxation that increasingly affects middle-income taxpayers and is projected to expand to impact nearly 35 million taxpayers in 2010. My 2003 report to Congress designated the AMT as the most serious problem facing taxpayers. I recommend that you eliminate the AMT or revamp it substantially to achieve its original objective – if that is possible.

# Complexity – AMT Example

- Mr. & Mrs. Brady live in California in a rented home with their six children ages 5 - 16. They claim the “married filing jointly” filing status and take the \$9,700 standard deduction for 2004.
- Mr. Brady, an architect, made \$73,160. Mrs. Brady worked part time as a teacher and earned \$25,000. The Bradys owe \$3,394 in taxes – before considering the AMT.
- Mr. & Mrs. Brady’s tax bill rises to \$4,442 with the AMT.



*{NTA - Federal Tax Reform - Notes for Slide 9}*

The Brady's pay \$1,048 in additional tax due to the AMT.

If Mr. and Mrs. Brady were not married and each claimed their 3 respective children and Head of Household filing status,

- Mrs. Brady pays no taxes and gets \$4,125 in refundable credits (EITC = \$1,987 and refundable CTC = \$2,138)
- Mr. Brady pays \$6,006 in taxes
- The combined tax would be \$1,881 ( $\$6,006 - \$4,125$ ) – or \$2,561 less than married filing joint with AMT.
- Neither would pay AMT.

This second scenario might have made for a more interesting TV show, but it's terrible tax policy!

# Complexity - Retirement

- More than a dozen tax-advantaged retirement planning vehicles in the Code.
- Proliferation of plans and rules cause confusion and may reduce participation.
- Need for uniformity
  - Hardship exception for early withdrawals.
  - Availability of plan loans.
  - Ability to roll over into other plans (portability).

see Retirement Table – Appendix

*{NTA - Federal Tax Reform - Notes for Slide 10}*

Retirement planning incentives are numerous and complex. More than a dozen tax-advantaged retirement planning vehicles are available and are subject to different sets of rules governing eligibility, contribution limits, the tax treatment of contributions and distributions, withdrawals, the availability of loans, and portability. I recommend that you take a hard look at the confusing array of options. I also suggest that you consider streamlining them.

Each year I appear on C-Span's Washington Journal – last year, 2 callers talked about being unemployed and taking early withdrawals from IRA retirement accounts just to get by – and they were hit with 10% additional tax for early withdrawals. Yet if they had been covered under different plans they wouldn't be hit by 10% additional tax. The hardship exceptions are different between plan types!

Aside from people being accustomed to the plan they have, what is the policy reason for allowing taxpayers to take early withdrawals from a 403(b) plan for financial hardships without penalty, but not allowing it for an IRA.

# Complexity - Education

- At least 9 separate education credits, deductions and income exclusions.
- There are 4 different measures of income, 6 different income threshold amounts, and 3 different definitions of “Qualified Higher Education” expenses.
- Education Information Package (IRS Pub. 970) contains 83 pages of text, flowcharts and worksheets.
- In 2002, approximately 6.5 million individual taxpayers claimed education tax credits totaling approximately \$4.9 billion.

*{NTA - Federal Tax Reform - Notes for Slide 11}*

The tax code provides a complex set of incentives to encourage saving for and spending on education, set forth in at least 9 different provisions. The requirements, definitions, and income phase-outs vary from provision to provision. The point of a tax incentive, almost by definition, is to encourage certain types of economic behavior, but taxpayers will only respond to incentives if they know they exist and understand them. Few, if any, taxpayers are both aware of all the education tax incentives and familiar with their particulars. In my 2004 Annual Report to Congress, I identify several recommendations to streamline and simplify these provisions, including a uniform definition of qualified higher education expenses.

A personal story –

- I prepared my son's taxes 2 weeks ago. He's going to school part time.
- The tax software selected the education provision it "thought" best.
- But for me to determine why that result was correct – on a very simple return – took me one and a half hours of intensive reading. And I'm still hard-pressed to know how to project and calculate which of these provisions will really be the most help for him next year!
- If anything, they were irrelevant to his incentives for pursuing his education, because complexity obscures the connection.
- And as his mother and tax return preparer – I'm thoroughly disincentivized!

# Compliance Rates



Withholding 99%

3<sup>rd</sup> Party Reporting 96%

Schedule C 68%

(This includes both amounts reported and not reported by 3<sup>rd</sup> parties to the IRS.)

*{NTA - Federal Tax Reform - Notes for Slide 12}*

Okay, now I've talked about a few examples of how complexity impacts taxpayers – your person on the street.

Clearly the tax codes must be simplified for many reasons – including making it easier for taxpayers to comply with the law.

Thus, in reforming the Code, you need to be aware of several compliance factors, as well as taxpayer attitudes towards compliance, in order to ensure that simplification proposals have a positive impact on compliance.

With all this complexity, how, and why do taxpayers comply?

Obviously withholding is a major driver of compliance – someone else takes the taxes out of taxpayers' paychecks and pays it over to the government.

And third party reporting acts as a “honesty” factor – taxpayers report their income when they know the IRS will find out anyway!

# Compliance Factors

- Withholding and 3<sup>rd</sup> Party Reporting are compliance facilitators.
- The cash economy is subject to little or no tax withholding or 3<sup>rd</sup> party income reporting.
- It is estimated that two-thirds of the gross tax gap is attributable to self-employed taxpayers.
  - This amount includes the “cash economy” – that is, sources of income that are not reported to the IRS.



*{NTA - Federal Tax Reform - Notes for Slide 13}*

Where there isn't withholding, or isn't a lot of third party reporting, compliance plummets – as we see with Schedule C/Sole Proprietors and self-employed taxpayers.

# What makes Taxpayers Noncompliant

- Drivers of noncompliance include:
  1. Complexity
  2. Programmatic and procedural flaws.
- Taxpayer attitudes toward compliance fall into three basic categories:
  1. Will comply
  2. Trying to comply
  3. Won't comply.

*{NTA - Federal Tax Reform - Notes for Slide 14}*

So, what makes taxpayers noncompliant?

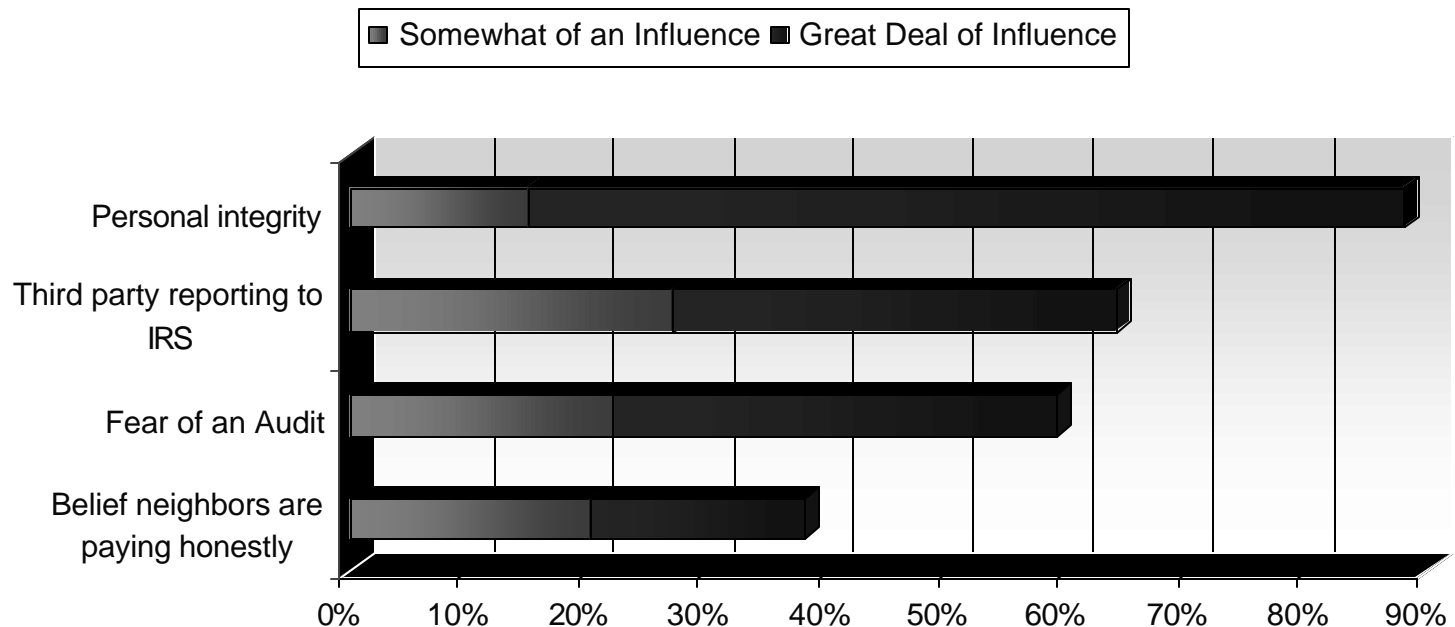
- It's not just the abstract complexity of the Code, but also the way it's administered.
- I think a lot about taxpayer attitudes toward compliance – if they aren't in compliance, are they at least trying to comply?
- What kind of hurdles does the law – or tax administrator – put up against a taxpayer who is trying to comply?
- Just how long will that taxpayer keep trying if we make it too hard?
- At what point will that taxpayer stop trying and become a taxpayer who “won't comply?”

We could do just the opposite – enact laws designed to help taxpayers comply so those who are trying, actually do become compliant.

[one consequence of the 86 Act – even up to 2001, people brought me medical and employee business expense receipts – their nursing uniforms! It's their expenses!]

# Deterrents to Non-Compliance

The strongest factor influencing tax reporting is  
**Personal Integrity**



Source: Roper ASW, 2003 IRS Oversight Board Compliance Study Report (Sept. 2003), pp. 10-11.

*{NTA - Federal Tax Reform - Notes for Slide 15}*

This information was published in the RoperASW, 2003 IRS Oversight Board Annual Survey on Taxpayer Attitude, September 2003, on pages 10-11.

Lots of people have cited the Oversight Board's study that showed that more taxpayers think it is okay to cheat. I think there is much more interesting information in the report, for example:

This report identified that many factors influence whether people report and pay their taxes honestly. The strongest factor influencing tax reporting is personal integrity (88%), with 73% saying it has a great deal of influence. Other factors have much less of an influence, including third parties reporting income (64%), fear of an audit (59%), and believing that your neighbors are reporting and paying honestly (38%).

# Types of Non-Compliance

- Procedural
  - Administrative complexity
- Lazy
  - Unwilling or unable to satisfy requirements
- Unknowing
  - Confusion about the rules
- Asocial
  - Classic tax cheating
- Brokered
  - Advice of tax professionals
- Symbolic
  - Perceived inequities in the tax laws or tax administration
- Social
  - Social or economic circumstance
- Habitual
  - History of non-compliance emboldened by “getting away with it”

*{NTA - Federal Tax Reform - Notes for Slide 16}*

Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 U. Kan. L. Rev. 1145, 1168-1177 (2003).

Building on the work of social scientists, some tax scholars have developed a typology of noncompliance.

It is not just enough to know that a taxpayer is noncompliant – we must know why.

Different tax law provisions will engender different types of noncompliance.

- Some can be avoided by better design and simplification – e.g., procedural and unknowing noncompliance.
- Others may be unavoidable – e.g., asocial noncompliance will always be addressed by traditional enforcement.
- Some respond to social norms – engendering either compliance or noncompliance.

# Communication

- How do we “touch” taxpayers?
  - Pre-Filing
  - Filing
  - Post-Filing
- How does the “touch” affect compliance?
  - Do we convert a taxpayer from “trying to pay” to “won’t pay” if we make the wrong type of “touch”?
- Taxpayers consider IRS-provided information valuable.
- People prefer phone or face-to-face contact.
- Procedures and forms should be evaluated and tested prior to implementation.



# Compliance



- Why should taxpayers comply?
  - Social Norm
  - Social Contract/Agreement with Taxpayers

*{NTA - Federal Tax Reform - Notes for Slide 18}*

So, when I think about simplification, from a taxpayer-centric point of view, I ask myself

- Why should taxpayers comply?
- We are asking taxpayers to come in and report their income and pay their taxes.
- What is government's end of that bargain?
- What does government owe taxpayers in exchange for their compliance with the tax laws?

# Tax Reform Considerations

Design a system that -

- Does not “entrap” taxpayers.
- For the majority of Americans, can be complied with on a single form and document matched.
- Allows most individual and small business taxpayers to fill out their own returns.
- Tax administrators can explain.
- Anticipates the largest areas of non-compliance.
- Does not create whole armies of industries.
- Provides choice – but, not too many options.

*{NTA - Federal Tax Reform - Notes for Slide 19}*

Well, here's my attempt at some basic principles – government has the responsibility to design a tax system that ...

- Does not “entrap” taxpayers – there are no arcane and technical “gotchas” such as the AMT or Roth IRA conversions.
- Anticipates the largest areas of noncompliance – i.e., reduce opportunities for noncompliance
- Does not create whole armies of industries – dependent upon it for their livelihood
- Provides choice – but not too many options – do we really need 9 education provisions?
-

# Tax Reform Considerations



- Refundable credits are not inherently problematic – it's all in the design.
- System should incorporate periodic review of the Code – in short, a sanity check.

*{NTA - Federal Tax Reform - Notes for Slide 20}*

Regarding refundable credits:

- We need to think through the elements, the opportunities for noncompliance, and then administer the refundable credit programmatically.
- There's no inherent reason why a refundable credit or other tax expenditure is undesirable; in fact, it may be very desirable. For example, if income is an eligibility requirement, maybe the program should be administered through the Code. Otherwise, the IRS would still have to identify the taxpayer's income to another agency – and that raises confidentiality issues!
- We do, however, need to understand the characteristics of any provision's target population, and treat a refundable credit as a separate program within the tax system – with a single administrative oversight - from education and outreach to enforcement -tailored to the program and its recipients.

Finally, we really need to come up with a mechanism that checks complexity creep!

- We really need to ask ourselves, when thinking about tax provisions,
- Why do we care about this provision?
- Do we really care?
- And if we do care, what are we going to do to make taxpayers comply? Is it worth it?
- I suggest to you that one reason why more taxpayers think it is okay to cheat on their taxes is because it is just too darn hard to get it right – it is just too complicated.

No system operates well without a strong sense of taxpayer rights. You will never have enough money to enforce every evader.

# Appendix



# TY 2002 Taxpayer Characteristics

Rural Population	21%
Urban Population	79%
Median Child Tax Credit	\$600
Median EITC	\$1,746
Median Dependent Care Credit	\$480



# Complexity - EITC

- For TY 2002, approximately 21.7 million taxpayers filed approximately \$38.2 billion in EITC claims.
- IRC § 32 contains 2,680 words (it has a Flesch reading ease of 31.3% and a Flesch-Kincaid grade level of 12.0).
- IRC § 32 contains 13 subsections [(a) through (m)].
- Publication 596, Earned Income Credit (EIC), contains 53 pages of forms, instructions and worksheets.
- For TY 2003, 71.5% of EITC claimants used a paid preparer.
- The EITC overclaim rate is estimated to be 27% - \$8.5 billion of the estimated \$31.3 billion in 1999 EITC claims were overclaims.
- The EITC examination rate was 1.65% in FY 2002.
- The IRS issued 1,083,090 math error notices in FY 2002.

# Complexity - AMT

- Hits taxpayers it was never intended to hit.
- Catches taxpayers by surprise.
- Adds insult to injury by subjecting many taxpayers to penalties.
- Add-on tax was enacted after Treasury reported that 155 taxpayers with AGI above \$200,000 in 1966 paid no tax; gave taxpayers \$30,000 exemption. If indexed, those figures would be \$1.16 million and \$153,500 today.
- Penalizes taxpayers for such "classic tax avoidance behavior" as having children or living in a high-tax state.
- In 2004, average AMT taxpayer is projected to owe additional \$6,000 in AMT (TPC 2004 estimate).
- To determine whether AMT liability exists, taxpayers must complete 12-line worksheet, read 8 pages of instructions, and complete 55-line form.
- In 2010, AMT is projected to hit 34.8 million taxpayers (Treasury estimate), including 94% of married couples with AGI between \$75,000 and \$100,000 who have two or more children (TPC 2004 estimate).

# Complexity - Retirement

- More than a dozen tax-advantaged retirement planning vehicles in the Code.
- Proliferation of plans and rules cause confusion and may reduce participation.
- Need for uniformity
  - Hardship exception for early withdrawals.
  - Availability of plan loans.
  - Ability to roll over into other plans (portability).

**SUMMARY OF RETIREMENT PLAN ELIGIBILITY, CONTRIBUTION & WITHDRAWAL PROVISIONS**

	<b>401(k)</b>	<b>403(b)</b>	<b>457(b)</b>	<b>Traditional IRA</b>	<b>Roth IRA</b>	<b>SIMPLE IRA</b>
<i>Who is eligible?</i>	Employees of all non-governmental employers	Employees of 501(c)(3) organizations and public education employers	Employees and independent contractors of state & local governments	Individuals (subject to income limitations if covered by employer-provided retirement plan)	Individuals (subject to income limitations)	Employees of businesses w/ fewer than 100 employees who received > \$5,000 compensation in preceding year
<i>Annual contribution limit (2004)</i>	\$13,000	\$13,000	\$13,000	\$3,000	\$3,000	\$9,000
<i>Tax-deferred contribution?</i>	Yes	Yes	Yes	Yes	No	Yes
<i>Tax-free withdrawal?</i>	No	No	No	No	Yes	No
<i>Minimum age for penalty-free distribution</i>	59 ½, unless separated from service	59 ½, unless separated from service	70 ½, unless separated from service	59 ½	59 ½	59 ½
<i>Hardship withdrawal allowed?</i>	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, if distribution is necessary to satisfy "immediate and heavy financial need"	Yes, for "unforeseeable emergency"	No	No	No
<i>Loan permissible?</i>	Yes, up to 50% of plan balance (\$50K max)	Yes, up to 50% of plan balance (\$50K max)	No	No	No	No
<i>Direct rollover allowed?</i>	Yes	Yes	Yes	Yes	Yes, to other Roth accounts	No

# Complexity - Education

- There are at least nine education provisions in the Code in the form of credits, deductions and income exclusions.
- IRS Publication 970, Tax Benefits for Education, contains 83 pages of text, flowcharts and worksheets.
- Among the education provisions, there are four different measures of income and six different income threshold amounts for qualification purposes.
- There are three different definitions of “Qualified Higher Education” expenses.
- In tax year 2002, approximately 6.5 million individual taxpayers filed income tax returns reporting education tax credits totaling approximately \$4.9 billion.
- Between October 1, 2003 and August 31, 2004, W&I started 1,713 audits, closed 1,887 audits, and assessed approximately \$1.2 million on audits related to IRC § 25A education tax credit .

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 25A: Hope and Lifetime Learning Credits	Credits gradually phase out after MAGI exceeds \$42,000 (\$85,000 for married taxpayers filing jointly) in Tax Year 2004.[1] Note that the credits are calculated as follows: <u>HSC</u> = 100% of first \$1,000 of qualified expenses and 50% of next \$1,000 of qualifying expenses. <u>LLC</u> = 20% of first \$10,000 of qualified expenses.[2]	The maximum Hope credit amount of \$1,500 is indexed for inflation.[3] The maximum Lifetime Learning Credit Qualified Expenses amount of \$10,000 is not indexed for inflation (but it increased from \$5,000 to 10,000 in Tax Year 2003).[4] Income thresholds for both credits are adjusted for inflation, subject to a \$100 rounding convention[5]	Credit reduction equals credit multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals \$10,000 (\$20,000 for married taxpayers filing jointly). [6]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent[7] For the Hope Credit, the student must be enrolled in one of the first two years of post-secondary school and must attend at least one semester half - time.[8]	"Qualified tuition and related expenses" includes tuition and fees required for enrollment, with specific exceptions for sports and hobby - related expenses and nonacademic fees.[9]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), which includes accredited post-secondary educational institutions offering a bachelor's, associate's, graduate level or professional degree in addition to a proprietary institutions of higher education, postsecondary vocational institutions; and approved foreign institutions of higher education.[10]

[1] IRC § 25A(d); IRS Publication 970, Tax Benefits for Education for use in preparing 2004 Returns, Catalog No. 25221V, 14, 22.

[2] IRC §§ 25A(b)(1), (c)(1).

[3] IRC § 25A(b)(4).

[4] IRC § 25A(c)(1).

[5] IRC § 25A(h).

[6] IRC § 25A(d).

[7] IRC § 25A(f)(1)(A).

[8] IRC § 25A(b)(2). Furthermore, the student will not be eligible if convicted of a felony drug charge. IRC § 25A(b)(2)(D).

[9] IRC § 25A(f)(1).

[10] IRC § 25A(f)(2).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§117: Exclusion of Qualified Scholarships	No income thresholds	N/A	N/A	Student must be a candidate for a degree. <sup>[1]</sup>	“Qualified tuition and related expenses” includes tuition and fees required for enrollment and fees, books, supplies and equipment required for courses. <sup>[2]</sup>	Educational organization described in IRC § 170(b)(1)(A)(ii), which includes primary, secondary and postsecondary schools. <sup>[3]</sup>

---

<sup>[1]</sup> IRC § 117(b)(1).

<sup>[2]</sup> IRC § 117(b)(2).

<sup>[3]</sup> IRC § 117(a).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§127: Exclusion of Education Assistance	No income thresholds	The maximum exclusion amount of \$5,250 is not adjusted for inflation.[1]	N/A	Student must be the Taxpayer and must be an employee.[2]	“Educational assistance’ is defined as the payment, by an employer, of expenses for education of the employer including, but not limited to, tuition, fees, and other similar payments, books, supplies and equipment. Does not include payments involving sports, games or hobbies.[3]	Not Specified. [4]

---

[1] IRC § 127(a).

[2] IRC § 127(a)(1).

[3] IRC § 127(C)(1).

[4] IRC § 127(b).



**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 135: Exclusion of Income from U.S. Savings Bond	The exclusion of income from U.S. savings bonds is gradually phased out once MAGI exceeds \$59,850 (\$89,750 for married taxpayers filing jointly) in Tax Year 2004. <sup>[1]</sup>	Income thresholds are adjusted for inflation, subject to a \$50 rounding convention. <sup>[2]</sup>	The exclusion reduction equals the exclusion multiplied by a fraction, the numerator of which is the excess of the MAGI over the income threshold amount, and the denominator of which is \$15,000 (\$30,000 for married taxpayers filing jointly). <sup>[3]</sup>	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent <sup>[4]</sup>	"Qualified higher education expenses" include tuition and fees required for enrollment. Such amounts include contributions to IRC § 529 or IRC § 530 accounts. Includes specific exceptions for sports and hobby - related expenses. <sup>[5]</sup>	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). <sup>[6]</sup>

<sup>[1]</sup> IRC § 135(b)(2)(B).

<sup>[2]</sup> IRC § 135(b)(2)(C).

<sup>[3]</sup> IRC § 135(b)(2).

<sup>[4]</sup> IRC § 135(c)(2)(A).

<sup>[5]</sup> IRC § 135(c)(2).

<sup>[6]</sup> IRC § 135(c)(3).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 221: Deduction of Interest on Education Loan	The deduction is gradually phased out after MAGI exceeds \$50,000 (\$100,000 for married taxpayers filing jointly) for Tax Year 2004.[1]	<p>The maximum deduction amount of \$2,500 is not indexed for inflation.[2]</p> <p>The income thresholds are adjusted for inflation, subject to a \$5,000 rounding convention.[3]</p>	Deduction reduction equals deduction multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals \$15,000 (\$30,000 for married taxpayers filing jointly).[4]	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent[5]	"Qualified higher education expenses" is defined as the "cost of attendance" as defined by § 472 of the Higher Education Act of 1965 (20 U.S.C 1087).[6]	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). The definition also includes institutions conducting an internship or residency program leading to a degree or certificate by an institution of higher education, a hospital or health care facility which offers post-graduate training. [7]

[1] IRC § 221(b)(2)(B)(i)(II).

[2] IRC § 221(b)(1).

[3] IRC § 221(f).

[4] IRC § 221(b)(2)(B).

[5] IRC § 221(d)(1)(A).

[6] IRC § 221(d)(2).

[7] IRC § 221(d)(2).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 222: Deduction for Qualified Tuition and Related Expenses	In 2004 and 2005, the deduction is limited to \$4,000 for taxpayers with AGI not exceeding \$65,000 (\$130,000 for married taxpayers filing jointly). The deduction is limited to \$2,000 for taxpayers with AGI not exceeding \$80,000 (\$160,000 for married taxpayers filing jointly). <sup>[1]</sup>	No inflationary adjustments. However, the amount of the deduction has increased from 2002/2003 tax years when the deduction was limited to \$3,000 for the lower income tier and zero for the higher income tier. <sup>[2]</sup>	No phase-out calculation, because deduction amount is limited and differs by income tier. <sup>[3]</sup>	Taxpayer, Taxpayer's Spouse or Taxpayer's Dependent <sup>[4]</sup>	"Qualified tuition and related expenses" include tuition and fees required for enrollment; fees, books, supplies and equipment which are a part of a degree program or related to an academic course of instruction. <sup>[5]</sup>	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). <sup>[6]</sup>

<sup>[1]</sup> IRC § 222(b)(2).

<sup>[2]</sup> IRC § 222(b)(2).

<sup>[3]</sup> IRC § 222(b)(2).

<sup>[4]</sup> IRC § 222(d)(1).

<sup>[5]</sup> IRC § 222(d)(1).

<sup>[6]</sup> IRC § 222(d)(1).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 408A: Roth IRA	Generally, the maximum nondeductible contribution of \$3,000 is gradually phased out after MAGI exceeds \$95,000 (\$150,000 for married taxpayers filing jointly). <sup>[1]</sup>	In general, the maximum contribution amount is scheduled to increase from \$3,000 in 2004 to \$4,000 in 2005 and \$5,000 in 2008 (and indexed for inflation thereafter). <sup>[2]</sup>	The maximum contribution reduction equals the contribution amount multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals \$15,000 (\$30,000 for married taxpayers filing jointly). <sup>[3]</sup>	Taxpayer, Taxpayer's Spouse, Taxpayer's dependent or grandchild. <sup>[4]</sup>	The 10 percent additional tax on early distributions is not imposed on early distributions used to pay for "qualified higher education expenses," which is defined in the same manner as IRC § 529(e)(3). <sup>[5]</sup>	"Eligible education institution" includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). <sup>[6]</sup>

<sup>[1]</sup> IRC § 408A(c)(3)(C).

<sup>[2]</sup> IRC §§ 408A(c)(2), 219(b)(5).

<sup>[3]</sup> IRC § 408A(c)(3)(C)(ii).

<sup>[4]</sup> IRC §§ 72(t)(2)(E), (7).

<sup>[5]</sup> IRC §§ 72(t)(2)(E), (7). Note that IRC § 408A does not mention "qualified higher education expenses. IRC § 72(t) provides an exclusion from the 10 percent additional tax imposed on early distribution from any IRA (not just Roth) to the extent used for qualified higher education expenses.

<sup>[6]</sup> IRC §§ 72(t)(2)(E), (7).

**SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS**

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 529: Qualified Tuition Plans	No income thresholds	N/A	N/A	No relationship requirement. There are beneficiary relationship requirements when changing beneficiary designations. <sup>[1]</sup>	“Qualified higher education expenses” include tuition, fees, books, supplies and equipment required for enrollment or attendance; special needs services for a special needs beneficiary which are incurred in connection with such enrollment or attendance; and certain room and board expenses. <sup>[2]</sup>	“Eligible education institution” includes any institution described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088). <sup>[3]</sup>

---

[1] IRC §§ 529(c)(3)(C), (5)(B).

[2] IRC § 529(e)(3).

[3] IRC §§ 529(e)(5).

## SUMMARY OF INCONSISTENCIES AMONG EDUCATION PROVISIONS

IRC Provision	Income Threshold	Inflation Adjustment?	Phase-Out Calculation	Relationship and Additional Requirements	Type of Expenses	Type of Educational Institution
§ 530: Coverdell ESAs	The maximum contribution of \$2,000 is gradually phased out after MAGI exceeds \$95,000 (\$190,000 for married taxpayers filing jointly). <sup>[1]</sup>	No.	The maximum contribution reduction equals the contribution amount multiplied by a fraction, the numerator of which is the excess of MAGI over income threshold amount and denominator of which equals \$15,000 (\$30,000 for married taxpayers filing jointly). <sup>[2]</sup>	No relationship requirement. There are beneficiary relationship requirements when changing beneficiary designations. <sup>[3]</sup> The student must be younger than age 18 at time of contribution. The account assets must be distributed when the beneficiary reaches the age of 30 unless the beneficiary has special needs. <sup>[4]</sup>	“Qualified education expenses” includes both “qualified higher education expenses” as defined by § 529(e)(3) and “qualified elementary and secondary education expenses”, which include expenses such as tuition, fees, academic tutoring, special needs services for a special needs beneficiary which are incurred in connection with such enrollment or attendance, books, supplies and other equipment, room and board, uniforms and transportation. <sup>[5]</sup>	Includes “eligible education institutions” described in § 481 of the Higher Education Act of 1965 (20 U.S.C. 1088), primary and secondary schools. <sup>[6]</sup>

<sup>[1]</sup> IRC §§ 530(b)(1)(A), 530(c).

<sup>[2]</sup> IRC § 530(c).

<sup>[3]</sup> IRC § 530(d)(6).

<sup>[4]</sup> IRC § 530(b)(1)(A)(ii).

<sup>[5]</sup> IRC § 530(b)(2)(A).

<sup>[6]</sup> IRC §§ 530(b)(3),(4)(B).

# Compliance – Returns Received

