

INTERNAL REVENUE SERVICE PROGRESS ON INITIATIVES RELATING TO PAPERLESS FILING, AND THE FEASIBILITY OF IMPLEMENTING A RETURN-FREE SYSTEM FOR APPROPRIATE TAXPAYERS

HEARING
BEFORE A
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COMMITTEE ON APPROPRIATIONS
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THURSDAY, APRIL 13, 2000

U.S. SENATE,
SUBCOMMITTEE ON TREASURY AND
GENERAL GOVERNMENT,
COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 2:51 p.m., in room SD-192, Dirksen Senate Office Building, Hon. Ben Nighthorse Campbell (chairman) presiding.

Present: Senators Campbell, Kyl, and Dorgan.

STATEMENT OF SENATOR CAMPBELL

Senator CAMPBELL. The hearing will come to order. Thank you, Mr. Rossotti, for having patience with us.

Around here, a lot of times when we are the busiest, that is when the votes occur, and there were three in a row. Senator Dorgan will be over in just a moment. Oh, he is here, he must have been running right behind me.

Today we will be talking about ongoing efforts at the IRS to move to paperless income tax filing. This is a particularly timely topic. Monday, April 17 will be a busy day and night at local post offices.

The IRS Restructuring and Reform Act of 1998 set an aggressive goal for the IRS. By 2003, all tax returns prepared electronically will also be filed electronically. Electronic filing saves the IRS time and money and increases the accuracy of its returns. Taxpayers will also benefit. They get their refunds faster and fewer mistakes are made.

This afternoon we hope to learn what the IRS is doing and plans to do to reach that goal. We also hope to learn more about other ideas to save the Federal Government some money, as well as relieve some taxpayers of the burden of even preparing tax returns.

Senator Dorgan has mentioned some of his ideas during other subcommittee meetings, and is much better versed than I, having in his prior life a great deal of experience with the IRS, as you know, Mr. Commissioner. He has also mentioned this on the floor, too.

I look forward to hearing the testimony. I have a couple of questions, and I also have a personal problem that I would like to bring to your attention, but I will do that during questioning.

Senator Dorgan, do you have an opening statement?

Did I hear that we are going to have another vote at 4:00, was it?

Senator DORGAN. It will not be 4:00. There is up to 4 hours of debate. They think it will not take 4 hours, but it is the budget resolution.

Senator CAMPBELL. I do not know your schedule, but we will try to get through this as timely as we can.

STATEMENT OF SENATOR DORGAN

Senator DORGAN. Let me also thank our witnesses for their indulgence. The votes occurring in the Senate are not always occurring on a timely basis, and so I appreciate your being here.

Mr. Chairman, I appreciate your scheduling with me this hearing to review the progress of the Internal Revenue Service and the Treasury Department to make tax day a paper-free for a lot of citizens in this country. I want to thank Mr. Rossotti for being here, the Commissioner, and also Assistant Secretary Burman for his attendance and participation.

On Monday it is filing deadline for income taxes in this country. I think many Americans in this country welcome the opportunity not to have to search for receipts, not to have to find a line to wait in at the post office on Monday night to try to get a midnight postmark on their tax return. Many Americans would be surprised to learn that over 30 countries that have income taxes have some form of a form-free filing system, in which you can actually meet your obligation in the income tax system without filing a tax return. We do not do that in this country, but in some 30 countries they do.

I have been working on a proposal and, as you know, the Congress has directed the Treasury and IRS to work on this and meet certain goals. It is very easy, I know, to pick proposals apart and much more difficult to construct them. But the purpose for putting together a proposal that I have developed, and will be introducing with my colleague Judd Gregg from New Hampshire and Dick Durbin from Illinois as co-sponsors, and I hope others, is to see if we cannot simplify the filing requirement for millions of Americans.

My proposition is very simple. I will just do it in about 3 or 4 minutes, at the most.

It is called the FASST Plan, the Fair and Simple Shortcut Tax Plan. It would allow up to 70 million Americans, I believe, to complete their obligations under the income tax system without actually having to file an income tax return.

How would they do that? They would, if they are eligible, and they would have to determine whether they are eligible. Individuals under \$50,000 in income or couples with married filing jointly under \$100,000 in income, would be eligible. They would make an election. Do I want to elect to file under this plan?

The plan would allow them to file a W-4 form with their employer that is slightly modified and will take account of several additional things, such as home ownership. The withholding table

that will come from their income, related to what they have chosen on their W-4, will be an exact withholding that will represent their exact tax liability and they will not have to file a tax return.

Is this too good to be true? Not at all. We can decide to do this as a country. It is not too difficult.

Not everyone's income fits into this circumstances. Some have very complicated income sets, they do not fit. Some earn substantial amounts of other income, non-salary income, they do not fit.

But if you are under \$50,000 single or \$100,000 married filing jointly, and have less than \$5,000 of other income from capital gains and interest income, you would fit and you could elect to decide I am not going to file a paper return anymore. My withholding at work will be my exact tax liability.

No more receipts, no more forms, no more waiting in lines at the post office. This is simplicity as it should be, and there is no other proposal I know of in Congress that would really simplify it. Virtually everything we do around here makes the tax system more complicated.

SIMPLICITY AND PAPERLESS TAX FILING

I have spent a number of years as a State tax administrator, I have worked on tax issues for a long, long time. And I decided a while ago that instead of just talking about simplicity, we ought to do something that will really ease the burden for millions of Americans.

My proposal, I believe, will allow about 70 million people to elect to do this if they choose. That would be a significant step forward.

Several advantages are a, for the de minimis income, there is no tax burden. That tends to encourage savings and investment. It is a terrific thing to do. We would flatten out the bottom rate so that under \$100,000 married filing jointly or \$50,000 single they are all paying the same flat bottom rate. That extends that bottom rate. I think that is a good thing to do.

We eliminate the paper, eliminate audits effectively, assuming there is no fraud. And it is not burdensome for the businesses that are required to house the W-4s and report them to the IRS.

I have a whole series of charts but I think, to be merciful, I will not go through the charts and we will take the testimony. Then I have some questions and perhaps, as I go through the questions, I can go through just a couple of these charts.

But this is a very simple concept. The Congress has signaled to Treasury and the IRS, I was part of sending that signal, as was my colleague, Senator Campbell, to say we want to move in this direction. The question is not whether, the question is how. And we want you to help us do that.

This is but one plan. There may be others and better plans, but it is the only plan I know of that would provide real tax simplification here in the U.S. Senate. This hearing is a first step to evaluate how we do this.

Why does the Appropriations Committee have a stake in this? Because you spend a lot of money processing paper. We spend money allowing you to hire warehouses to put all this paper in. The fact is, we can eliminate a substantial amount of this paper

for millions and millions of Americans, and we ought to move in that direction with a simplified income tax system.

Mr. Chairman, thank you. I am anxious to hear the testimony from both of our witnesses.

STATEMENT OF CHARLES O. ROSSOTTI, COMMISSIONER, INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

Senator CAMPBELL. Please proceed, Mr. Rossotti.

Mr. ROSSOTTI. Thank you very much.

Before I start, I just wanted to wish the chairman a happy birthday. I heard on the radio this morning that it was your birthday, Mr. Chairman. I hope it was a correct report.

Senator CAMPBELL. That is what the elevator operator tells me. I do not keep track myself.

Senator DORGAN. It is your birthday today?

Senator CAMPBELL. Yes.

Senator DORGAN. Happy birthday.

Senator CAMPBELL. Happy anniversary.

Senator DORGAN. It is my 15th anniversary.

Mr. ROSSOTTI. I am glad that that was an accurate report.

Senator CAMPBELL. It was an accurate report, so they tell me.

Mr. ROSSOTTI. I would be embarrassed if it was not.

Senator CAMPBELL. We were so poor when we were kids, I was in an orphanage when I was a little guy. We did not celebrate any special days. I guess I grew up without even thinking about it. Unless somebody tells me, it just goes right on by. Sometimes they have to tell me how old I am, as well as it is my birthday.

Mr. ROSSOTTI. I am very pleased to be here to talk about return-free filing. Of course, I do want to stress to all taxpayers as we approach the deadline, that we already have some important improvements in place that can help taxpayers do electronic filing. I just wanted to note that it looks like we are going to be up about 17 percent this filing season, electronic filing. It will be close to 35 million returns. So we have made some headway in that regard.

But going beyond that, and looking longer term, we do note that the restructure format says that the Secretary of the Treasury will develop procedures to implement a return-free filing system for appropriate individuals by 2007 and we are required to make reports beginning this year to the tax-writing committees on the progress in this regard.

We have started on that work. The first report will be due later this year and we will, at that point, focus on reviewing past studies and looking at, in particular, taxpayer attitudes. Because we want to make sure that if we design something it is what taxpayers actually want.

I will just give you a little interim report here that we have completed preliminary analysis of some of our work on taxpayer attitudes with some focus groups. Interestingly, the preliminary returns here show that taxpayers this time seem to have a more positive attitude about this idea than they did the last time it was studied some years ago, which was fairly negative actually. I guess that reflected the idea that somehow people did not trust the IRS to somehow prepare their tax return.

This time, at least so far, we have gotten about an equal split between those that are favorable and those that are less favorable. It is not a statistically valid sample yet, but this is at least a preliminary indication that there is a more positive point of view on the part of the public towards this idea.

We have also had an opportunity to briefly review the draft legislation written by Senator Dorgan. We have had an opportunity briefly to chat about it. I think it is unquestionable that this bill provides some important simplification proposals and possibilities for making things easier for taxpayers. It does raise some administrative issues and I just want to stress, as I said to the Senator, we would welcome the opportunity to work with you to review these issues and get your input and try to figure out how we could solve these problems as part of our overall requirement under RRA to study return-free filing.

ISSUES IN PAPERLESS FILING

I will just mention briefly what I consider the three sorts of categories of issues that we have to deal with as we move forward on this proposal. One is just to define the content of the election certificate or the document that the taxpayer would file with the employer, which would allow then the employer to calculate the exact amount of tax. There are some issues here. For example, we would have to decide how taxpayers, whether they would provide some of the data on Social Security numbers and other information that is now required for dependents and for determining who is a qualified child under the EIC program.

We also have to discuss how to handle certain kinds of employment and filing scenarios, such as when employees have more than one employer during the year, married filing joint filers where both spouses are working, and taxpayers who divorce or separate during the year. Those are some issues we would have to deal with in that area.

Another area is to define a little bit about the process that we would need to verify in some form the amounts that were withheld by the employer and what to do with the certificates or other documents, whatever they would be, that would be filed by the employer with the employees during the year.

Currently the IRS does not receive W-4 forms. They are just held by the employer. So we would have to determine when and how these documents might be sent to the IRS and whether we would process them when we did.

Of course, one of the issues that I think we talked about with the Senator is if the taxpayer did have a balance due or a refund after we did the verification, even though it would be the expectation that the withholding would be the exact amount, in the exception cases we would have to determine when we dealt with those.

Right now, because of when we receive the information from the Social Security Administration and the employers, we would not be able to do that until around October or November. We would have to make sure that was acceptable to the taxpayers.

COMPLIANCE ISSUES

Finally, there are some compliance issues that we would have to study, such as the issue of what to do about one of the more common situations that arise, where the taxpayers submit certain data on either dependents or qualifying children or other people that are qualifying for certain credits. This is one of the more common errors that occur and we currently verify a lot of these things during the return processing process and get back to the taxpayer to make corrections. So we would have to determine how we would do that sort of verification.

So I just wanted to briefly mention, those are kind of the general categories of issues. I am not suggesting that any of these cannot be solved, but they would require some work, I think, to work with the committee and other parties to resolve them.

So just to conclude, I want to stress that we in the IRS, I think, view it as one of our major missions in life to figure out how to reduce taxpayer burden using whatever tools and resources we have. We are already doing some things in that regard, I think, effectively with respect to electronic filing and making that easier and more accessible. And now following the direction of Congress in the Restructuring Act, with the assistance of this committee, we will continue to work on this return-free concept using whatever research we have and the inputs of Senator Dorgan and others to try to come up with the best solution possible.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF CHARLES O. ROSSOTTI

INTRODUCTION

Mr. Chairman and distinguished Members of the Subcommittee, I am pleased to testify today on return-free tax filing, specifically as it relates to the Internal Revenue Service's mandate under the IRS Restructuring and Reform Act of 1998 (RRA 98), and within the broader context of easing taxpayer burden and improving tax administration.

As we approach this year's April 17th filing deadline, let me reemphasize the IRS' commitment to reducing taxpayer burden and providing taxpayers top quality service. Although we have taken some important first steps, the IRS still does not meet the legitimate service expectations of America's taxpayers. We must take advantage of new technologies and best business practices to improve service and reduce the broad spectrum of taxpayer burden—not just when taxpayers file their returns, but throughout the year.

STRATEGIES TO REDUCE TAXPAYER BURDEN

Interacting with taxpayers is a three-part process: (1) Pre-filing—services provided to a taxpayer before the return is filed to assist in filing a correct return; (2) Filing—services provided to a taxpayer in the process of filing returns and paying taxes; and (3) Post-filing—services provided to a taxpayer after a return is filed, such as to identify and correct possible errors or overpayments and underpayments.

One of the overriding themes of the IRS modernization plan is shifting from addressing taxpayer problems well after returns are filed to addressing them earlier in the process. Indeed, we want to prevent problems wherever possible throughout the filing process, which gives us some enormous opportunities to reduce taxpayer burden. Let me briefly discuss four areas in the pre-filing and filing processes where we can make improvement.

First, the IRS communicates with millions of taxpayers each year through multiple channels: mail, telephone, Internet and in-person. These communications range from tax forms and publications describing how to file, to phone calls setting up installment agreements, to in-person meetings to resolve longstanding issues and disputes.

From the taxpayer's point of view, the quality of these communications has been well below expectations. Enhancing the convenience and quality of our communications with taxpayers, and thereby reducing taxpayer burden, is a critical component of our modernization plan.

In the past two years, we have made some significant progress on the communications front, including expanding the hours of phone service during filing season to 24 hours a day, seven days a week, providing Saturday hours at more than 275 walk-in sites throughout the country, and rewriting some notices and forms to make them easier to understand and use.

The IRS web site (the "Digital Daily") has also proved to be a very successful, convenient and popular communications tool, providing immediate access to all forms and publications, as well as answers to many tax questions. In 1999, the Digital Daily had over 767 million "hits" during which taxpayers downloaded more than 57 million forms and publications.

Our long-term goal is more ambitious. We must organize communications so that taxpayers can get accurate and prompt information and correct resolution of issues in a time and manner most convenient for them. Given the scale and complexity of our operations, this is a multi-year task requiring fundamental change in all aspects of IRS' operations, including organization and management, training of front-line personnel, internal and external distribution of information, information technology and performance measurements.

Second, one of the keys to easing taxpayer burden, particularly in filing, is expanding the use of electronic tax administration. Electronically-filed returns improve service for taxpayers and boost productivity by reducing errors, speeding refunds and reducing labor costs. Although electronic filing has been increasing rapidly, 77 percent of returns are still filed on paper.

Reaching the RRA 98-mandated goal of 80 percent electronically-filed returns will require many improvements within the IRS. An effective and efficient electronic filing system depends on replacing IRS' archaic technology and implementing new business practices. These improvements include: enhanced technology to allow filing of a full range of returns and schedules; resolution of security issues to eliminate requirements for separate signature documents; tailoring of marketing and education programs to attract taxpayers and practitioners with varying needs; and broadening the number of effective payment options in conjunction with filing.

The opportunities to improve business practices through electronic communications with customers and practitioners go far beyond the filing of returns. As previously discussed, customer education and assistance programs through the IRS web site, such as distribution of forms and publications and answers to tax law questions, are growing rapidly. Eventually, secure communication over the Internet with practitioners and taxpayers will be used to resolve taxpayer account issues, facilitating resolution of examinations, providing taxpayers authorized transcripts of their accounts and generally improving the timeliness and quality of the full range of IRS interactions with taxpayers.

Third, we can also help reduce taxpayer-filing burden by leveraging IRS resources through effective partnerships. There are many organizations and groups that are actively involved in tax administration and interact regularly with taxpayers. For example, the Electronic Tax Administration Advisory Committee (ETAAC) serves as a public sounding board for our electronic filing programs. Historically, the IRS has worked with many of these organizations to share information about IRS programs and taxpayer concerns and, in the case of states, to exchange information for compliance purposes.

In the future, the IRS must place a far greater emphasis on forming partnerships with all of these groups to reach solutions on taxpayer issues, and especially to improve taxpayer education and assistance. Many of these organizations have established communications channels with millions of taxpayers and are enthusiastic about working with the IRS to help their members avoid tax problems and relieve their burden. A large number of taxpayers are also more likely to listen to and trust information that comes from organizations with which they deal on a regular basis, rather than directly from the IRS.

We also want to energize our volunteer return preparation programs, such as Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE), and co-locate these activities at our Taxpayer Assistance Centers. This will not only help taxpayers with the filing process, but it will allow the IRS to focus on simple account and collection issues.

Furthermore, we have opened up VITA and TCE offices in locations that are close to our assistance centers and offices observing EITC Awareness Days, providing an additional avenue of support to taxpayers visiting an IRS office for EITC assistance.

In addition to this type of volunteer assistance, our outreach program targeted expanding EITC education and assistance. We identified EITC coordinators in our offices who are responsible for the full complement of EITC outreach activities. While no data is available yet for fiscal year 2000, this program reached 174,067 EITC taxpayers during fiscal year 1999 through social workers, community organizations, homeless shelters and faith-based organizations.

Our challenge for the 2000 filing season was to provide volunteers with the necessary tools to assist taxpayers. To this end we loaned 5,300 computers and 3,400 printers and provided software (TAXWISE) to volunteer sites. We are also identifying communities that would benefit from EITC programs and recruiting volunteers through the Internet.

The states offer special opportunities for using resources and improving service to taxpayers. Since most taxpayers deal with at least one state as well as the IRS, there is a great deal of overlapping information, providing significant opportunities for reducing taxpayer burden.

For example, last year, the IRS and the Montana Department of Revenue tested a Simplified Tax and Wage Reporting System (STAWRS) where Montana employers were able to take advantage of combined Federal and State filing. STAWRS reduced taxpayer burden on small businesses by combining into one tax return the information contained in the IRS employment tax return (Form 941), the Montana withholding return and the Montana unemployment insurance return. State government partnership programs will enable us to meet our joint mission as tax administrators to reduce employer burden while improving the efficiency and effectiveness of government operations.

Fourth, just as companies develop particular products and marketing programs to reach customers with differing needs, so must the IRS tailor practices and strategies based on specific taxpayer needs and problems.

Tailoring IRS services to particular groups of taxpayers is a cornerstone of how we can dramatically improve our service to taxpayers, and reduce burden, as well as increase productivity within the organization. Virtually all IRS services can be improved using this principle. Pre-filing assistance programs, such as customer education, telephone and Internet assistance and publications and form design, all represent obvious opportunities for clearer and more effective communications.

Filing-related programs, such as electronic filing, telephone account assistance and notices also need to be tailored to suit the needs of individual, small business and large business taxpayers. Return-free tax filing would fall into this category especially as we determine "the appropriate individuals" best suited to use such a program.

In addition, post-filing compliance programs offer major opportunities to allocate resources more effectively based on knowledge of specific issues affecting taxpayers in particular industries or business situations. In turn, the post-filing knowledge gained from working with taxpayers in examination and collection can be used to develop improved guidance and education programs to prevent future problems, thus reinforcing the problem prevention strategy.

Understanding taxpayer problems and needs, and tailoring and improving programs to meet these needs, is so fundamental to meeting IRS' strategic goals that it must be a key organizing principle for the way the IRS is managed.

RETURN-FREE FILING

Section 2004(a) of RRA 98 states that the Secretary of the Treasury or the Secretary's delegate shall develop procedures for the implementation of a return-free tax system for appropriate individuals for taxable years beginning after 2007. The Secretary is also required to make the first report on the development of the return-free tax system to the tax-writing committees by June 30, 2000. The report will include the following information:

- What additional resources the IRS would need to implement such a system;
- The changes to the Internal Revenue Code of 1986 that could enhance the use of such a system;
- The procedures developed;
- The number and classes of taxpayers that would be permitted to use the procedures.

Also, the first report will review prior studies that were conducted to determine the feasibility of a return-free tax system and to discuss the concerns and issues that were raised.

PREVIOUS STUDIES AND REPORTS

The return-free tax system concept has been a topic of discussion in this country for the past 20 years. There have been various studies and reports issued concerning this system; notably two General Accounting Office (GAO) reports issued in October 1996 and May 1992, as well as IRS studies dating back to 1984. I would like to briefly discuss the IRS reports.

Final Report on Implementing a Return-Free Tax System (September 1985)

This first report identified a number of key issues relating to return free filing that would also be raised in future studies, e.g. timeliness of refunds, change in filing date of information returns, resource implications, and the link between Federal and State tax systems.

The report concluded that a return-free tax system would indeed be revolutionary and the ramifications would extend to legal, administrative and taxpayer behavioral issues. It was believed that the system would require acceleration of processing, which in the long run, would permit quicker and better enforcement action and would strengthen compliance. The major concern was that the success of such a system would greatly depend on basic elements such as public opinion and acceptance, and the quality of information reporting.

IRS Feasibility Study (October 1987)

The IRS considered the Return-Free Tax System concept during the drafting of the Tax Reform Act of 1986. As noted, the concept had been a topic of discussion at IRS for several years and a task force developed a detailed design of such a system in 1984; another task force followed up with a detailed cost estimate for the aforementioned 1985 report. The two reports were used as the basis for the 1987 Feasibility Study.

The system described in the 1987 report assumed eligible taxpayers would elect to allow the IRS to prepare their returns and compute any liability using information provided to IRS by employers and payors. In order to participate, taxpayers would have to return a postcard to IRS containing their filing status, Social Security number, whether they were dependents on someone else's return and certifications of their eligibility. The taxpayer-supplied information would be matched with the employer/payor information and a return would be generated based on this information. Either a refund or a balance due notice would be issued.

The study concluded that the Return-Free Tax System was not feasible at the time. The key issues identified included:

- Timing of information return processing would delay refund generation;
- Accuracy of information returns was a concern;
- Participants would not receive their IRS prepared tax returns in time to file their state returns;
- Additional costs could be incurred by the IRS.

Moreover, at that time, the IRS was in the process of expanding its electronic filing program. Electronic filing was viewed as the best way to reduce costs as well as to speed up the existing filing of individual returns, most notably the time it would take to get refunds.

IRS Value Tracking Focus Group (1993)

The IRS conducted 20 focus group sessions with individual and small business taxpayers to explore their perceptions about the Agency and the services it provided, as well as new services being considered at the time, including alternative filing methods. One of the alternative filing methods discussed by the participants was return-free tax filing. It should be noted, however, that during the focus group testing, taxpayers were asked only how they would feel about the IRS preparing their returns based upon information received by the IRS from third parties. Taxpayer reaction was extremely negative, based in part on a general distrust of the IRS. A few of the issues the taxpayers cited were:

- A lack of trust in the IRS' ability to prepare their taxes accurately;
- Dissatisfaction with receiving tax refunds later in the year; and
- The feeling of giving complete control to the IRS.

Very few participants supported the return-free concept as presented to them. They believed that its greatest advantage was reducing taxpayer burden when preparing returns. However, even those supporting the method emphasized the importance of being able to challenge the IRS' assessment if they disagreed with it, or if their tax situation changed.

YEAR 2000 STUDY AND BEYOND

Mr. Chairman, the IRS recently completed an attitudinal study on return-free filing. It consisted of four focus groups in New York City, Ft. Lauderdale, Dallas and Los Angeles. This "qualitative" phase was undertaken to evaluate taxpayer reaction to the concept of a return-free tax filing system, and particularly, if taxpayer perceptions had changed since the 1993 focus groups conducted by the IRS. We will apply what we learn from this phase to the "quantitative" telephonic survey that will begin later this spring.

While we are still analyzing the results of the focus groups, I can say that participants were most interested in the return-free tax-filing concept. Furthermore, the initial reaction was equally mixed between positive and negative responses. However, once again, I want to stress that this was a qualitative study that was intended to explore perceptions rather than to provide the statistically valid database on return-free tax filing we hope to achieve with the quantitative telephonic study.

FASST PROPOSAL

Mr. Chairman, the IRS has reviewed the draft legislation written by the distinguished Ranking Minority Member Senator Dorgan proposing a return-free tax system, also known as the "Fair and Simple Shortcut Tax Plan" (FASST).

Although the IRS cannot discuss the tax policy aspects of the proposed legislation, we certainly understand and appreciate the taxpayer's point of view when it comes to ease of filing, especially the ability to file one election form at the beginning of the year and not have any further filing responsibilities.

The draft legislation is most thought provoking, and raises a number of interesting topics that I would like to briefly discuss today. The IRS would also welcome the opportunity to sit down with Senator Dorgan, potential co-sponsors and staff to work through these questions as the present draft of the bill is fine-tuned.

The first topic is the new FASST election certificate that employees would have to fill out and provide to their employers. It posed a number of questions including the following:

- What exactly would a taxpayer file with the employer?
- What information would the taxpayer have to provide to an employer?
- How would FASST deal with the administrative challenge of an employee having multiple employers?
- What happens under FASST if both spouses are working?
- How would the IRS get the information it needs to determine whether there is an overpayment or underpayment of taxes?

Our second topic focuses on the W-2 form that taxpayers now receive in January containing critical filing information. The draft legislation raised some interesting questions about how this information would be provided to FASST taxpayers.

- Unless the W-2 form is modified, what could be done to ensure that employees would receive a record of important deductions and credits that their employer took into account, such as EITC, child care credit and homeowners' expense deduction?
- Since the IRS does not receive the W-2 tape from the Social Security Administration until August, what can we do to provide timely refunds to FASST taxpayers, or notices of additional tax due?
- What can we do to help employers and employees quickly resolve potential disputes over amounts or credits reported on a W-2?
- What can be done to minimize the costs to employers of changing their systems to be able to provide new information on W-2s?

Our third topic involves how the IRS would actually go about administering a system as different and unique as FASST while still maintaining the existing system for non-FASST taxpayers. In this regard, we have a few basic questions, such as:

- Given its enormous importance to reducing taxpayer error and boosting compliance, what could be done to ensure that the IRS continues to receive Social Security numbers for dependents claimed as exemptions and qualifying children for EITC?
- What could be done to help employers when a FASST taxpayer loses eligibility, but fails to notify his/her employer(s)?
- What can we do to minimize the impact on both FASST taxpayers and the IRS when there is a dispute over IRS' computations of an underpayment or overpayment?

Once again, these are some very broad topics raised by the FASST legislative proposal. We are most grateful for the opportunity to review this legislation in its draft form and to work with Senator Dorgan and all interested parties to provide some answers to the questions we posed today.

CONCLUSION

Mr. Chairman, in conclusion, the IRS is committed to reducing taxpayer burden at every possible opportunity using every tool and resource at our disposal. Following the clear directions set forth by Congress in the Restructuring Act, we will use the research now underway as the foundation to further explore the return-free system as another means of reducing taxpayer burden. Thank you.

STATEMENT OF SENATOR KYL

Senator CAMPBELL. I wonder, Senator Kyl, do you have an opening statement before we ask some questions?

Senator KYL. I do, Mr. Chairman. Let me just make a brief statement and ask that a complete statement be put in the record.

I appreciate what Senator Dorgan is trying to do here, but I have a big concern about what the effect will be. Everyone wants to minimize the impact on taxpayers. There is one respect in which minimizing the impact on taxpayers is not a good idea, and that is if they no longer have an idea of how much they are paying in taxes. I think the more they understand what their taxes really are, the more careful they are about who they elect to public office, what decisions they make, what they support, because they see a closer relationship between what they earn, what they have to pay in taxes, and decisions that are made.

The more we remove taxpayers from that, the further away they get from having the knowledge base for their judgments. And tax withholding today, income tax withholding today, masks to some extent the burden. My staff, we did a little survey and only about a third of my staff knew how much was withheld from their paycheck.

Other taxes are masked, as well. The employer share of FICA taxes, you do not even see that on your pay stub, even though it is a dollar for dollar reduction in pay, and so on.

So Mr. Chairman, and with all due respect to Senator Dorgan, I understand what he is trying to do here to minimize the work of taxpayers, and we all share that goal. I do not, at the same time, want to minimize their ability to see very clearly what they are paying in income taxes to the Federal Government. It seems to me that we should work to make that part of any solution that aims to reduce their burdens, as well.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR JON KYL

Mr. Chairman, I want to thank you for convening this hearing today to hear from Commissioner Rossotti and Deputy Assistant Secretary Burman about the Internal Revenue Service's review of initiatives relating to paperless filing and the feasibility of implementing a return-free system for certain taxpayers.

A return-free system may well be an easier and more convenient way for taxpayers to satisfy their tax obligations. Millions of taxpayers would no doubt welcome a simpler system. As it stands now, individuals and businesses are having to deal with 481 separate IRS tax forms for 1999. That is up 20 percent since just 1990.

The IRS estimates that Americans will spend 6.1 billion hours—over three million person-years—to comply with the Federal tax system. Compliance alone will cost taxpayers in the neighborhood of \$200 billion, and that is before they even satisfy their tax obligations.

Mr. Chairman, a return-free system may prove more convenient for taxpayers, but I, for one, want to urge caution here and express some concern about the idea. I know Senator Dorgan is well intentioned in his desire to simplify compliance for taxpayers, but I believe the idea will have some unintended results.

This morning, I conducted an informal survey of my staff to see whether they pay attention to how much is withheld from their paychecks or whether they just focus on take-home pay, since that's what they depend on to make ends meet. Only about a third knew exactly how much was withheld. My guess is that is representative of taxpayers at large. They're more concerned about making ends meet, and they assume taxes are a given anyway.

The point is, income-tax withholding as it exists today already helps reduce the visibility, and minimize our awareness, of making tax payments. FICA taxes paid by an employer on behalf of an employee never show up on a worker's pay stub at all, even though they reduce wages dollar for dollar. Corporate income taxes and the cost of government regulations imposed on business certainly add to the price of every good and service that a consumer purchases. Sales taxes are accepted as part of the price of consumer goods. By the time Election Day rolls around, even the pain of filing one's income-tax return is long forgotten. Election Day could hardly be farther away from April 15.

There is good reason for that. Politicians don't want to ask for people's votes when the tax burden is still fresh on their minds.

I've actually advocated moving the deadline for filing income-tax returns from April 15 to Election Day as a way of helping to focus people's attention on their tax burden at the very time of year they have the most opportunity to do something about it.

Mr. Chairman, we need to make taxes more visible, not less visible. It seems to me that a return-free system would eliminate the end-of-year accounting that lets people see just how great a tax burden the government is imposing on them. I know that is not the intent of advocates of this proposal, but I think that will be the result. It will also make it easier for the government to increase that burden in the future, when taxpayers are not focused on what their liability is.

There are some other problems with a return-free system that should be considered, as well. Perhaps the foremost concern involves privacy. This is something that Deputy Assistant Secretary Burman touched on in his written testimony.

Taxpayers would have to share more personal and financial information with their employers in order to determine the correct withholding allowances. Would taxpayers really want to share private information with their employers? I think there will be a lot of concern about that.

Second, with a return-free system in place, would the IRS notify people when they have had too much tax withheld? It is my understanding that about 1.7 million taxpayers either overlooked, ignored, or otherwise failed to claim the child-tax credit allowed them under the law in 1998. That means an estimated \$1 billion in excess taxes were collected by the Treasury.

The Inspector General for Tax Administration has recommended that these taxpayers be sent an informational notice about their entitlement to the child-tax credit. This notice would be similar to the notice that has been used to inform taxpayers that they may qualify for the Earned Income Tax Credit.

I have been advised, though, that IRS management is resisting sending such notices. I hope Commissioner Rossotti will address this during his comments today. If the IRS won't tell taxpayers now that they've paid too much, what incentive will they have if a return-free system is in place, when taxpayers won't ever have to sit down and reconcile their tax liability? What happens when people forget to change their withholding to reflect changes in family circumstances—a new child, a new home, or devastating, unforeseen medical expenses?

Mr. Chairman, I really believe we need to proceed very carefully. Simplifying compliance is one thing, but we should not make it easier for Washington to take even more from hardworking Americans when they're not looking.

IMPACT OF PAPERLESS FILING

Senator CAMPBELL. Let us talk about the impact a little bit.

As I understand it, one of the benefits of Senator Dorgan's proposal is to reduce the paperwork processing at the IRS, which would in turn save money. What impact would that have on your personnel needs and on your budget? I know it is pretty hard to guess.

Mr. ROSSOTTI. We clearly do not know until we define the proposal a little bit. I think that the biggest part of this idea is to eliminate the burden on the taxpayer to have to prepare a return. In some sense, it actually adds some things to what we have to do,

in the sense that we then have to, instead of just verifying, actually compute what this liability is, at least the sense of verifying it at the end, even though hopefully in most cases it would not require sending anything back to the taxpayer.

One of the key issues in costs is what we would have to do, as I mentioned this is one of the issues we have to study, what we would do with the election certificates or enhanced W-4 forms, as they are called I guess, that the taxpayer would have to file with the employer. Because they would file them with the employer in order to determine what their tax was for withholding.

Right now, those kind of forms are just held by the employer. Nothing is done, we do not even receive them. So I am not sure yet at this point, without further study, what would actually have to be done with those.

If we assume that we might have to receive those forms from the employer, otherwise we would not have any information to verify how the liability was computed, then in effect what we have done is we have substituted that form for processing the tax return, and we sort of balance those out to some degree.

So I guess what I would say is that I, from what little study we have done so far, this is in an early stage, I really see that the benefits of this proposal have to do more with reducing the burden on the taxpayer than they do with reducing the cost to the IRS. That is as best as I can answer your question at this point.

Now I do not necessarily think that is bad, because I think generally what we are trying to do is reduce the burden on the taxpayer, which is a much bigger number than what the cost is in the IRS. I mean, some people say that the total cost of compliance for the whole tax system may be as much as eight to nine times what the cost is for the IRS budget.

So that is really the big number out there, as opposed to what the IRS budget is.

Senator CAMPBELL. I have a few more questions. Do you have a statement, Mr. Burman? Go ahead and proceed with it.

STATEMENT OF LEONARD BURMAN, DEPUTY ASSISTANT SECRETARY OF TREASURY FOR TAX ANALYSIS, INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

Mr. BURMAN. Mr. Chairman, Senator Dorgan, Senator Kyl, I appreciate the opportunity to participate in this hearing on return-free tax systems. I want to thank the chairman for calling a very important hearing, and Senator Dorgan for his leadership in this area.

The goal of tax policy is to raise revenue in an equitable, efficient and simple manner. Often, the goals of equity, efficiency, simplicity, and fiscal responsibility are in conflict. The tax system that is perceived as equitable may be complicated, while a system that is simple may be unfair or inefficient.

The individual income tax which finances the largest share of the Federal Government's operations is the fairest and most progressive broad-based tax. In fact, the Federal income tax burden for a median income family of four is lower today than it has been since 1965. Nearly 70 percent of files have a statutory marginal tax rate of 15 percent or lower.

The income tax makes important adjustments to reflect differences in ability to pay. In addition, the income tax provides taxpayers with important incentives for saving, investment, for charitable contributions, and rewards work by low income people. It helps people pay for essential needs, such as child care, home ownership, education, and health insurance.

However, this flexibility comes at a cost, as many perceive the current system to be complex and income tax compliance to be burdensome. Thus, this hearing which examines ways to reduce taxpayer compliance burdens without undermining the basic fairness of the income tax is extremely important.

What is the best way to make income tax compliance less burdensome? One option that has been adopted by more than 30 countries is a return-free filing system. In most of these countries, taxpayers meet their tax obligations entirely through tax withholding payments made throughout the year. Other countries rely on so-called tax agency reconciliation in which tax authorities prepare tax returns for individuals based on information returns from employers and others and send taxpayers a completed tax form for their review.

In the United States, this administration proposed to reduce taxpayer burdens by simplifying the tax law, encouraging electronic filing, telefiling, and the use of tax preparation software. As described by the Commissioner, the IRS has underway a number of innovations designed to make its contact with taxpayers less burdensome. It is in the written version of his testimony.

My oral testimony will very briefly discuss the trade-offs that must be considered in moving toward a return-free system, summarize the British experience with their system, and discuss the potential for removing American taxpayers from the filing roles.

THE BRITISH SYSTEM OF PAPERLESS FILING

The British system illustrates the important trade-offs required to move to a return-free system. As in many so-called pay as you earn systems, the unit of taxation in the United Kingdom is the individual. The system has fewer rates with about 80 percent of taxpayers taxed at the basic rate of 22 percent. Taxes on interest and dividends are withheld at the source at the basic rate. Capital gains on owner occupied housing are completely exempt from tax. Other capital gains are indexed for inflation and subject to a generous annual exemption.

Fewer deductions are allowed than in the United States and taxpayers claim these deductions through different mechanisms. For example, mortgage interest relief is provided at the source at a 15 percent rate. There are fewer tax preferences and they are not typically targeted by income.

As a result of these features, about two-thirds of British taxpayers are able to avoid filing tax returns. Those who have to file are largely high income taxpayers with asset income, those with capital gains above the exempt amount, and those with self-employment income.

Further, while low income families do not have to file a tax return in order to claim the British EITC, which is called the working family tax credit there, they must submit a separate applica-

tion that looks a lot like a tax return to Inland Revenue twice a year.

Neither an exact withholding or tax agency reconciliation system, which is in effect in only Denmark and Sweden, provides an easy way to handle capital gains, business income, alimony, or other payments between individuals, employee business expenses, moving expenses, contributions to individual retirement accounts, most itemized deductions or most tax credits.

If the United States were to adopt either system, many taxpayers would still be required to file a return, even with significant structural changes to the tax code. Most systems also raise administrative concerns. I turn next to a discussion of these issues. I should emphasize at the outset that this discussion is basically aimed at framing issues that need to be addressed. They are not necessarily criticisms of the concept.

The first issue concerns the withholding formulas applicable to wage income. In 2001, approximately 21 million taxpayers out of 128 million will have income solely from wages, will claim no credits other than the child tax credit, will not itemize deductions, and will be in either the zero or 15 percent tax bracket. For these taxpayers, tax liabilities equal 15 percent of wage income above the standard deduction plus exemptions less than \$500 per child tax credit. Because almost all wage income is subject to withholding already, these taxpayers could most readily be shifted into a return-free system.

WITHHOLDING AND PAPERLESS FILING

Even though most wages are subject to withholding, the current system would have to be modified in several ways in order to make withholding exactly match tax liability for most of these taxpayers. Additional information and computations would be required on the form W-4 to accurately adjust withholding for the child tax credit.

Further, the current withholding formulas are not designed to be exact for dependent filers, dual career couples, or taxpayers who do not work all year or have more than one job during the year. If only non-dependent files with income solely from one job were exempted from the return filing requirement, only about 8.5 million taxpayers would qualify.

Withholding formulas could be modified to meet the needs of most taxpayers but at the cost of some complexity. Under an exact withholding system, some workers would have to file forms W-4 more frequently during the year, whenever their family or financial status changed in a way to affect tax liability, for example if they married, divorced, or have a baby. They might also have to share more personal and financial information with their employers in order to determine the correct withholding allowances. This would raise concerns about privacy.

Although the United States has never had a return-free tax system, we did try to implement more exact withholding rules in 1987, as required by the Tax Reform Act of 1986. The accurate but complex form W-4 had to be withdrawn in response to complaints from taxpayers, employers and the Congress who found the improved form unfathomable.

Expanding the scope of mandatory withholding raises a second set of issues. If withholding at the source were extended to interest dividends, pensions, IRA distributions and unemployment insurance benefits, 43.5 million taxpayers could be eligible for a return-free system.

Mandatory withholding has other advantages. For example, it would improve compliance, but it is controversial. Past attempts to extend withholding requirements to non-wage income have met with significant resistance from banks, financial institutions, and other businesses. However, it is possible that the increased usage and substantially lower cost of computer processing of business financial records can make withholding more feasible than when it was last attempted 20 years ago.

To further reduce administrative costs, relatively small payments and some payers, such as individuals who hold seller-financed mortgages, could be exempted from the withholding requirements. But that would either require more recipients to file or the exemption of such income from tax.

A 13.5 million more taxpayers could be exempted from a return filing requirement if eligibility for the EITC could be determined without a tax form. Administering the EITC in the absence of a return filing requirement raises other issues. Eligibility and credit computations are very sensitive to changes in family status and income during the year, making it difficult to accurately predict a taxpayer's credit amount in advance.

The British have addressed this problem by establishing a separate claims application process for their WFTC. Thus, they have not been able to totally eliminate some form of filing requirement.

ADMINISTRATION OF PAPERLESS FILING

In sum, depending on the extent of changes to current tax administration, the final tax return requirement could be eliminated for between 8 and 57 million taxpayers, or up to 44 percent of the tax filing population without making any structural changes to the code.

While these taxpayers would be spared the cost of preparing a final return, the net reduction in burden might not be that great. Most of these 57 million taxpayers currently file the relative simple 1040A and 1040EZ. Even under a return-free system, these taxpayers would still be required to provide some of the information from these forms to the IRS on a regular basis. In fact, the return-free process may be more complex than filing for some taxpayers.

There are additional concerns, including the extent to which some administrative costs would merely be shifted from taxpayers to their employers, other payers, and the IRS. Adoption of an exact withholding system means shifting some costs to taxpayers and employers by expanding the scope and precision of withholding. This is likely to meet with some resistance.

In the alternative tax agency reconciliation system, one billion information returns would have to be filed earlier and processed and perfected much sooner by the IRS in order to complete returns by April 15, and refunds might be paid out slower than under the current system.

States whose tax systems piggyback on the Federal tax return would also incur additional costs or delays under either system. A key issue in either system is who would bear responsibility for mistakes on the tax form prepared by the tax authority or mistakes in exact withholding made by either the tax authority or the employer or payer.

I raise these issues not as obstacles but as design issues that must be addressed before we could adopt a return-free system. Many of these issues were first considered in a report issued by the IRS in 1987. In that report, the IRS found that there were serious timing and accuracy problems in implementing a return-free system, but that technological improvements in IRS' processing could make a return-free system more feasible in the future.

We are working with the IRS to explore all of these issues as part of the process of answering the mandate the Commissioner spoke about.

This concludes my remarks. We look forward to working with the Congress to make the tax system work better for all Americans. I appreciate the opportunity you have given me to testify and I would be happy to answer questions.

[The statement follows:]

PREPARED STATEMENT OF LEONARD E. BURMAN

Chairman Campbell, Senator Dorgan, and Members of the Committee: I appreciate the opportunity to participate in this hearing on return-free tax systems. I want to thank the Chairman for calling this very important hearing and Senator Dorgan for the leadership he has shown in this area.

The goal of tax policy is to raise revenue in an equitable, efficient, and simple manner. Often, these goals—equity, efficiency, simplicity, and fiscal responsibility—may be in conflict. A tax system that is perceived as equitable may be complicated, while a system that is simple may be unfair or inefficient.

The individual income tax, which finances a large share of the Federal government's operations, is the fairest and most progressive broad-based tax. By basing tax liability on income and certain personal characteristics, it provides a mechanism to adjust for differences in ability to pay. However, this flexibility comes at a cost, as many perceive the current system to be complex and income tax compliance to be burdensome. Thus, this hearing, which examines ways to reduce taxpayer compliance burdens without undermining the basic fairness of the income tax, is extremely important.

What is the best way to make income tax compliance less burdensome? One option that has been adopted by over 30 countries is a return-free filing system. In most of these countries, taxpayers meet their tax obligations entirely through tax withholding payments made throughout the year. Other countries rely on tax agency reconciliation, in which tax authorities prepare tax returns for individuals based on information returns from employers and others, and send taxpayers a completed tax form for their review. In the United States, this Administration proposed to reduce taxpayer burdens by simplifying the tax law and encouraging electronic filing, telefiling, and the use of tax preparation software. As described by the Commissioner, the IRS has underway a number of innovations designed to make its contact with taxpayers less burdensome.

A number of issues must be considered in evaluating options to implement a return-free filing system.

- What changes in tax law and procedures would be required to facilitate a return-free filing system? How would these changes affect other objectives of the tax system, such as equity?
- Would a return-free system shift compliance burdens from individual taxpayers to employers and financial institutions?
- Would such a system result in a loss of privacy, because individuals might, for example, have to report to their employers information about their family circumstances and other sources of income to enable exact withholding?
- To what extent would taxpayers have to file some sort of report during the year, containing some of the same information currently included in tax returns, to

establish the proper withholding schedule or their eligibility for credits, such as the earned income tax credit (EITC)?

—What would be the role of the IRS, and what additional resources would be required to implement and operate a return-free system?

—What would be involved in coordinating State income tax systems with the new return-free apparatus?

—Are there other ways to achieve the benefits of a return-free tax system at less cost and without sacrificing other goals?

In my testimony today, I will address the sources of taxpayer burden in the current system, alternative models of return-free systems and the experience of other countries in implementing such systems, and the potential effects of such systems in the United States. Finally, I will briefly discuss the Administration's legislative proposals that would reduce taxpayer compliance burdens.

CURRENT LAW FILING REQUIREMENTS

Every income tax system imposes certain obligations, beyond the actual payment of taxes, on taxpayers, government agencies, and third parties. Individuals must provide the tax agency and possibly their employers with some basic information about their income and family status. Employers and other third parties withhold taxes on income, and must report both the amount of income paid and taxes withheld to the taxpayer and the tax agency. The tax agency must compute the individual's taxes to determine if the correct amount has been paid. Income tax systems around the world obtain the required information and collect taxes in different ways.

As the Commissioner has described, in the United States, taxpayers interact with the IRS in three stages: pre-filing, filing, and post-filing. The pre-filing stage often begins the day taxpayers start work, when they compute the number of withholding allowances they are entitled to claim. Taxpayers may also pay estimated taxes in quarterly installments throughout the year. They may also need to keep records documenting expenses and other items that affect their tax liability.

Throughout the year, businesses, non-profit organizations, and Federal and State government agencies also incur tax compliance costs. Employers must withhold Federal income taxes on wages and transmit these amounts to the Treasury. Under certain circumstances, income taxes may also be withheld during the year on unemployment benefits, distributions from pensions and individual retirement accounts, interest, dividends, and large gambling winnings. During the first three months of each year, businesses and other payers send over a billion information reports (Forms W-2, 1099, and others) to taxpayers, the IRS, and the Social Security Administration (SSA), showing the amount and type of income received and taxes withheld, if any, during the preceding year.

This filing season, about 127 million taxpayers will complete the second stage of tax compliance by completing and filing a tax return. Through tax returns, taxpayers notify the IRS of their actual income, filing status, and dependents, and they reconcile the amounts of taxes paid during the year with the amounts they owe the Federal government. Over 85 percent of these filers are legally required to file a tax return. In most cases, they are required to file because they incurred a positive individual income tax liability, but 7 million filers are required to file even though they do not owe income taxes in order to claim a dependent or to pay self-employment income taxes or other special taxes. About 15 percent (over 18 million filers) file a return even though they are not required to do so in order to obtain a refund of overwithheld income taxes, the EITC, or for other reasons.

The third stage of tax compliance—post-filing contacts—may begin shortly after the IRS receives a return. During processing, the IRS may detect mathematical or clerical errors and send notices to taxpayers advising them of adjustments that have been made to their tax returns. Later in the year, when SSA and IRS have finished processing and editing information reports, the IRS will match Forms W-2 and 1099 to tax returns, contacting taxpayers if discrepancies are found. After further review, the IRS may identify other returns as being questionable, and as a consequence, an audit may be initiated, resulting in the issuance of a notice of deficiency to the taxpayer. Altogether, about 9 million notices will be sent this year. Less than 7 percent of tax filers will actually have contact with the IRS during the post-filing stage.

In differing degrees, each of these three stages imposes burdens on individuals, employers, other third parties, and the Federal government. The cost of administering all Federal taxes is reflected in the \$8.6 billion budget of the IRS, but we cannot easily disentangle the costs to the Federal government of operating just the individual income tax. Costs to individuals, employers, and other third parties are even more difficult to measure.

Recently, significant technological advances have likely lowered taxpayer compliance burdens. Personal computers and tax software have become more widespread, powerful, and cheap. Tax software enables taxpayers to input data, and let the computer do complicated computations. It also simplifies information reporting by businesses. Technology has also helped tax professionals do research through the creation of on-line services and CD-ROMs. The IRS has built on these technological advances to reduce taxpayer compliance burdens. During the 1999 filing season nearly one out of every four taxpayers (over 29 million) filed electronically, including about 6 million taxpayers who telefile their return over the phone. Some States now allow taxpayers to file their Federal and State taxes in one electronic transmission. An IRS web site enables taxpayers to download forms and publications to their own computers. This site registered over 750,000 “hits” during fiscal year 1999.

The costs of administering the current tax system should be weighed against the benefits of the current system. In fiscal year 2000, the Federal government will raise nearly half of total Federal receipts—\$951.5 billion—from the individual income tax system. The tax is fair, contributing significantly to the overall progressivity of the U.S. tax system, without placing undue tax burdens on typical families. In fact, the Federal income tax burden for a median income family of four is lower today than it has been since 1965. Nearly 70 percent of filers have a statutory marginal tax rate of 15 percent or lower. In addition, the income tax provides taxpayers with important incentives for savings and investment, for charitable contributions, and for work effort by low-income individuals.

TYPES OF RETURN-FREE SYSTEMS

In contrast to the U.S. system with its end-of-year reconciliation on tax returns, over 30 countries exempt some of their taxpayers from the requirement to file a tax return. During the past decade, two States—Michigan and Louisiana—have enacted “no-form” pilot programs. There are two types of return-free tax systems, exact withholding and tax agency reconciliation, with many possible variations on each type.

Exact withholding.—In an exact withholding system, the tax agency attempts to insure that the exact amount of tax liability is withheld so that taxpayers are not required to file returns at the end of the year to obtain refunds or pay a balance due. Over 30 countries operate exact withholding systems. These systems require taxpayers to report some information to either employers or the tax authorities at the beginning of the tax year. The information is used to calculate withholding allowances by either the employer or the tax authority (who must then report the applicable withholding rates back to the employer in a timely fashion). Taxpayers may be required to report this information on a regular basis or whenever there is a change in their circumstances that affects income tax liability.

Several types of exact withholding systems exist. Cumulative systems (used in the United Kingdom) aim to withhold exactly the right amount of taxes at each point in the year. Final withholding systems (used in Germany and Japan) make adjustments to the final paycheck in the tax year to achieve exact withholding. Exact withholding systems typically apply a PAYE (“pay as you earn”) tax withholding plan for wage income.

Tax systems that rely on exact withholding often have structural features that facilitate taxation at source. For example, the individual—not the married couple—is generally the unit of taxation. Interest and dividend income is often made exempt or taxed at the source at a flat rate. Relative to the U.S. income tax system, PAYE systems are also characterized by fewer rates, fewer deductions, and fewer tax credits. This means that employers and other payers can withhold the appropriate amount of tax from taxpayers without obtaining significant amounts of personal and financial information from taxpayers (such as spousal income, medical expenses, or child care costs).

The British system illustrates the important relationship between tax structure and tax administration. As in many PAYE systems, the unit of taxation in the United Kingdom is the individual. The system has fewer rates, with about 80 percent of taxpayers taxed at the basic rate of 22 percent. Taxes on interest and dividends are withheld at the source at the basic rate. Capital gains on owner-occupied housing are completely exempt from taxes, as compared to the United States, where gains under \$500,000 (\$250,000 if unmarried) are exempt. Other capital gains are taxed on an inflation-adjusted basis and only realized gains in excess of 7,200 pounds (about \$11,400) per person are subject to taxation. There are also fewer itemized deductions, and the manner in which taxpayers may claim these deductions differs from the U.S. system. For example, mortgage interest relief is provided at the source at a 15 percent rate. There are fewer tax preferences, and they are

not typically targeted by income. Similarly, deductions are not subject to income-based caps.

In net, about two-thirds of British taxpayers were able to avoid filing tax returns for tax year 1999–2000. Those who have to file are largely high-income taxpayers with asset income (which are subject to tax withholding at the basic marginal rate), those with capital gains above the exempted amount, and those with self-employment income. Further, while low-income working families do not have to file a tax return in order to claim the EITC-like “Working Family Tax Credit,” they must submit a separate return-like application at the end of each six-month period to Inland Revenue.

Tax agency reconciliation.—Taxpayers may be relieved of the burden of filing even in systems that do not have exact withholding. In tax agency reconciliation systems, taxpayers can elect to have the tax agency prepare their return, with tax filing occurring in four steps. First, electing taxpayers provide basic information to the tax authority. The tax authority then calculates tax liabilities, given the information returns it receives from employers, financial institutions, and other payers, and the information obtained from the taxpayer. The taxpayer then has a chance to review (and contest) these calculations. Finally, refunds or tax payments are made.

Because withholding does not have to be exact, tax agency reconciliation systems may not place as great a burden on employers and other payers as exact withholding systems. Moreover, it may be easier in a tax agency reconciliation system to apply progressive rates to a combination of income derived from different sources and to allow taxpayers to claim certain types of deductions or credits. But tax agency reconciliation systems are not costless to employers, other third party payers, or the tax authorities. In order to ensure timely payment of refunds and balances due, payers must report payments to the tax authorities as close to the end of the tax year as possible, while the tax authorities must quickly absorb, process, and match a large number of information returns. Taxpayers must review these calculations and institute procedures, if necessary, to contest erroneous calculations.

Only two relatively small countries, Denmark and Sweden, operate tax agency reconciliation systems. About 85 percent of Denmark’s taxpayers and 74 percent of Sweden’s taxpayers had their returns filled out by the tax authorities in 1994.

Neither an exact withholding nor tax agency reconciliation system provides an easy way to handle capital gains, business income, alimony or other payments between individuals, employee business expenses, moving expenses, contributions to individual retirement accounts, most itemized deductions, or most tax credits. If the United States were to adopt either system, many taxpayers would likely still be required to file a return, even with significant structural changes to the current tax code. Both types of systems also raise new administrative concerns. We turn next to a discussion of these issues.

ADMINISTRATIVE ISSUES IN SHIFTING TO A RETURN-FREE TAX SYSTEM

The Internal Revenue Service Restructuring Act of 1998 requires the Secretary of the Treasury to develop procedures for the implementation of a return-free system for “appropriate” individuals by 2007. Until then, the Secretary is required to report annually on the additional resources the IRS would need to implement a return-free tax system, the changes to the Internal Revenue Code that would enhance such a system, the procedures developed for the implementation of a return-free tax system for appropriate individuals, and the number and classes of taxpayers that would be permitted to use these procedures.

Today, I would like to preview some of the administrative issues that we will examine in this year’s report as we begin to identify individuals for whom a return-free tax system would be appropriate under the current individual income tax.

The first issue concerns the withholding formulas applicable to wage income. In 2001, approximately 21 million taxpayers (out of 128 million taxpayers) will have income solely from wages, will claim no credits other than the child tax credit, will not itemize deductions, and will be in either the 0- or 15-percent tax brackets. For these taxpayers, tax liabilities equal 15 percent of wage income above the appropriate standard deduction and exemption amounts minus the \$500 child tax credit. Because almost all wage income is subject to withholding already, these taxpayers could be shifted into a return-free system more easily than the rest of the filing population. An additional 1.5 million taxpayers have all of the above qualifications but face a marginal tax rate higher than 15 percent.

Even though most wages are subject to withholding, the current system would have to be modified in several ways in order to eliminate a filing requirement (or to minimize refunds or balances due) for most of these 21 million taxpayers. Additional information and computations would be required on the Form W-4 to accu-

rately adjust withholding for the child tax credit. Further, the current withholding formulas are not designed to be exact for dependent filers, dual-career couples, or taxpayers who do not work all year or have more than one job during the year. If only non-dependent filers with income solely from one job were exempted from a return-filing requirement, only about 8.5 million taxpayers would qualify.

The withholding formulas could be modified to meet the needs of most taxpayers, but the additional precision would make the computation of withholding allowances on Form W-4 more complex. Under an exact withholding system, workers might have to file Forms W-4 more frequently during the year, whenever their family or financial status changed in a way to affect tax liability (for example, if they marry, divorce, or have a baby). They might also have to share more personal and financial information with their employers in order to determine the correct withholding allowances, raising privacy and security concerns.

Although the United States has never had a return-free tax system, we have had experience trying to fine-tune withholding formulas. When the IRS introduced a new, more precise Form W-4 in 1987, as required by the Tax Reform Act of 1986, it was quickly withdrawn in response to criticism from taxpayers, employers, and the Congress who found the new form complicated and burdensome.

Expanding the scope of mandatory withholding raises a second set of issues. If withholding at the source were extended to interest, dividends, pensions, individual retirement account distributions, and unemployment insurance benefits, the number of taxpayers eligible for a return-free tax system would increase to 43.5 million. Mandatory withholding would expand the scope of a return-free system and could improve compliance, but would create new administrative costs for financial institutions and other payers.

Past attempts to extend withholding requirements to non-wage income have met with significant resistance from banks, financial institutions, and other businesses. The increased usage and substantially lower costs of computer processing of business financial records may have made withholding more feasible than when last attempted nearly 20 years ago. To further reduce administrative costs, relatively small payments and some payers (such as individuals who hold seller-financed mortgages) could be exempted from the withholding requirements, but that would either require more recipients to file or the exemption of such income from tax.

An additional 13.5 million taxpayers could be exempted from a return-filing requirement if eligibility for the EITC could be determined through other means. Administering the EITC in the absence of a return-filing requirement raises a third set of issues. Eligibility and credit computations are very sensitive to changes in family status and income during the year, making it difficult to accurately predict a taxpayer's EITC in advance. The British have responded by establishing a separate claims application process for the Working Family Tax Credit (WFTC). Thus, they have not been able to totally eliminate some sort of filing requirement for WFTC claimants.

In sum, depending on the extent of changes to current tax administration, a final tax return requirement could be eliminated for between 8 and 57 million taxpayers, or up to 44 percent of the tax filing population, without making any structural changes to the tax code. While these taxpayers would be spared the costs of preparing a final return, the net reduction in burden may not be great. Most of these 57 million taxpayers currently file the relatively simple 1040A or 1040EZ. Even under a return-free system, these taxpayers would still be required to provide some of the information from these forms (for example, filing status and dependents' identification) to the IRS on a regular basis. In fact, the return-free process may be more complex than filing for some taxpayers.

Additional concerns include the extent to which some administrative costs would merely be shifted from the taxpayers to their employers, other payers, and the IRS. Adoption of an exact withholding system means shifting some costs to taxpayers and employers, by expanding the scope and precision of withholding. This is likely to meet with some resistance. In a tax agency reconciliation system, one billion information reports would have to be filed earlier and processed and perfected much sooner by the IRS in order to complete returns by April 15, and refunds might be paid out slower than under the current system. These requirements would add to the burden on employers, other third parties, and the IRS, and yet taxpayers may be reluctant to participate in the new system because of possible delays in their refunds, even with the acceleration of delivery and processing of information reports. States whose tax systems piggyback on the Federal tax return would also incur additional costs or delays under either system. A key issue in either system is who would bear responsibility for mistakes on the tax form prepared by the tax authority or mistakes in exact withholding made by either the tax authority or the employer/payer.

I raise these issues not as obstacles but as design issues that must be addressed before we could adopt a return-free system. Many of these issues were first considered in a report entitled, "Current Feasibility of a Return-Free Tax System, prepared by the IRS in 1987. In that report, the IRS found that there were serious timing and accuracy problems in implementing a return-free system, but that technological improvements in IRS's tax processing could make a return-free system more feasible in the future.

As I discussed earlier in my testimony, there have been significant technological improvements that have eased compliance burdens, even with a return-filing requirement. It is possible that these new technologies will also enable us to make the transition to a return-free filing system with minimal burden to certain categories of taxpayers. It is also possible that these technological advances will allow us to find other ways to reduce compliance burden while maintaining an end-of-year filing requirement.

ADMINISTRATION PROPOSALS TO REDUCE COMPLIANCE BURDENS

In the meantime, there are a number of steps that can be taken to reduce taxpayer compliance burdens without sacrifice of other policy goals. In his testimony, Commissioner Rossotti has described administrative steps taken by the IRS to lessen these burdens.

The fiscal year 2001 budget contains a number of proposals that will reduce taxpayer compliance burdens by simplifying the tax laws. Most notable among these is a proposal that would build upon the temporary AMT reforms enacted on a bipartisan basis last year. This proposal would permanently modify AMT calculations by removing the dependent personal exemption as a preference item. By 2010 when it is fully phased in, this change would reduce the number of taxpayers affected by the AMT by over one-half. In addition, the fiscal year 2001 budget would reduce the number of itemizers by 4 million and the number of dependent filers by 400,000 by increasing standard deduction amounts. Other proposals would reduce record-keeping for taxpayers by simplifying the child dependency tests and indexing the maximum exclusion for capital gains on the sale of personal residences.

Some progress has already been made. President Clinton proposed and signed into law 40 tax simplification measures as part of the Taxpayer Relief Act of 1997. As a result of that simplification, 99 percent of homeowners will not have to pay capital gains tax when they sell their home; 9 out of 10 corporations no longer have to worry about complex AMT calculations; and many dependent children are able to earn more income without being subject to tax.

Technological advancements provide other means to reduce taxpayer compliance burdens, rather than through eliminating a filing requirement. Electronic filing eases tax computations and reduces both taxpayer errors and the need for subsequent contacts between the taxpayer and the IRS. It also permits taxpayers to receive their refunds faster and provides taxpayers with immediate proof of filing. Recognizing these benefits, the 1998 Act sets a goal for the IRS of having 80 percent of tax year 2006 returns filed electronically.

To help achieve that goal, the Administration has proposed in the fiscal year 2001 budget a new temporary, refundable tax credit for electronic filing of individual income tax returns. The credit would be \$10 for each electronically filed return and \$5 for each TeleFile return filed for tax years 2001 through 2006.

This concludes my remarks. We look forward to working with the Congress in making the tax system work better for all Americans, for example, by enacting simplification provisions contained in the fiscal year 2001 budget. Thank you once again for providing me with the opportunity to testify. I would be pleased to answer questions.

IRS COMPUTERS AND PAPERLESS FILING

Senator CAMPBELL. Thank you.

For either of you, the IRS is currently working to develop a modern computer system and this committee has provided a considerable amount of money in the last few years. If the tax laws are changed significantly to accommodate this, or any similar proposal, is that computer system going to have the flexibility to adapt to this new system?

Mr. ROSSOTTI. I certainly hope so, and it should.

Senator CAMPBELL. Me, too.

Mr. ROSSOTTI. I think that, having said that, it does not mean that there would not be additional work that would be required. Because what you would have essentially, depending on the details, is you would still have all of the issues that you have today because it would be an elective system. And then you would have to add some additional requirements or additional features really, just to deal with the second process, that elected for the return-free process.

So I do not think it would make obsolete, or in any way impair at all, the investment that we were making in modernizing our systems. I think that would be a great platform, an essential platform really to do these new things. But there would be some additional work that would be required.

Senator CAMPBELL. If we went to a flat tax system, or simplified it with something along that line, would that mean the computer system would also be simplified?

Mr. ROSSOTTI. I think there are certain aspects of the computer system that would be simplified, but I think one thing to understand is that the actual application of the rate is a relatively small matter. That is a computational matter. Most of the computer systems investment, most of the processing investment, in fact most of the IRS budget does not go to simply computing that number. It goes, first of all, to just processing the data, especially verifying the data that goes into the income which the rate is then applied to.

So I think that certainly having anything that simplifies the system is better from an administrative point of view. No one can say that is not the case. But simply changing the rate, by itself, only affects one of the variables.

Senator CAMPBELL. I see. Well, the individual would not have to file a tax return but the IRS would still be responsible for preparing the necessary tax tables. So you would have to move some people around. Some would have to be moved up and some down and we, at this point, would not have any idea about how it would affect your manpower; is that correct?

Mr. ROSSOTTI. I think that what we could say is that it very much depends on what would happen with the taxpayers and how exactly we would handle the taxpayers who elected to have this return-free system. More specifically, what would have to be done with the election certifications or W-4s, whatever forms they filled out with the employers.

If you assume that what would happen is they would send those forms to us, either the employee would or the employer would, if that is what we would assume because that is what we would need to verify at some point, the accuracy of the withholding, then we would have to have employees and we would have systems to process those forms.

But I think it is not clear at this point exactly how that process would work.

Senator CAMPBELL. Since this is Senator Dorgan's idea, I probably should have asked him rather than you. But I do not have any further questions, I am sure the Senator does.

COMPLEXITY OF TAX ADMINISTRATION

Senator DORGAN. Mr. Chairman, thank you.

Within the last month I was in a manufacturing plant that produces rockets and rocket engines. As I was walking around that plant, I was marveling at how incredibly complicated it is to manufacture a rocket, a Titan rocket, to lift a payload and deposit a satellite or something else into space. Building a rocket is complicated, a tax system is not. That is simply creating an administrative procedure.

Having been a tax administrator, I can tell you that it is easy for us to claim it is complicated but in fact, it is not. We can create a system that does what we want it to do. And all of those things that we do that are different require different challenges that we meet.

But the purpose of this is to respond to this circumstance. Total number of pages of Federal tax rules going from 1913 to 2000, you see the graph, what is happening here, of course. And we are doing this.

Senator CAMPBELL. It was not complicated in 1913.

Senator DORGAN. It was not very complicated in 1913. This is not your fault, this is a result of rules and regulations that respond to laws that we pass. And the tax system is increasingly complicated, there is no question about that.

With respect to Senator Kyl's comments, he is absolutely correct. We do not want to do anything that would prevent taxpayers from understanding what their obligation is. But making things more complicated or less complicated and making the right choice between more and less complicated has nothing to do with whether taxpayers understand their obligation.

All taxpayers under the current system get a W-2 form. It shows what their income was and how much they had withheld for Federal income taxes. And they will, under this system, get a W-2 form with exactly the same information. It seems to me if you are facing a choice of more complicated or as complicated or less complicated, you would always choose a system that is less complicated, providing the taxpayers still understand their obligations. So I think that is not of interest as a concern here.

Commissioner Rossotti, in your testimony, I think you were anticipating that a return-free system would necessarily have the Internal Revenue Service computing the tax. That is not necessarily the case. There are two ways to do a return-free system.

As I think has been testified to by Mr. Burman, over 30 countries have some version of a return-free income tax system. One approach is an exact withholding approach, and the other is where the tax agency actually reconciles and prepares the tax return. I think there are two countries in which the tax agency solely reconciles and prepares the return.

But that is not my proposal. You understand, do you not, that there are different approaches?

Mr. ROSSOTTI. Yes.

Senator DORGAN. I am not suggesting that you reconcile and prepare the tax return.

IRS RESPONSIBILITIES WITH PAPERLESS FILING

Mr. ROSSOTTI. No, I think I did. I guess what I am still not sure of is what our responsibilities would be with respect to verifying the amount withheld. I think that is just a matter that would have to be studied some more because, somehow or other, I am assuming that if an employee filed something with their employer and that resulted in exact withholding, that we would still have an obligation in some way to verify that. Otherwise, there would be no independent check on whether that was the correct amount or not.

And it is really in that context that I was talking about it. And only if there was a difference would we do something about it. I guess I thought I understood the bill, but maybe I misread it, that if there was a difference outside a certain dollar amount we would then either send the taxpayer a refund or a bill.

But it was really in the context of verification that I was making my comments. I am just not sure quite how that would work at this point.

Senator DORGAN. Mr. Burman, are you familiar with the work of Mr. Gail, William Gail at the Brookings Institute?

Mr. BURMAN. I am.

Senator DORGAN. I assume you are. He has done a fair amount of work, as I think one of your colleagues has, with Mr. Gail. You raised as the Commissioner did, a number of considerations and I think all of those are valid issues. You raise, for example, the consideration of withholding on non-salary income. My proposal would not suggest that because you would not be able to elect to use the return-free system that I have described unless you were under the de minimis level of other income, \$5,000 for married filing jointly or \$2,500 for single.

So you would not have to be concerned about withholding at the source of non-salary income if you adopted a system of the type I have described; is that not correct?

Mr. BURMAN. That is right, as long as the non-salary income is below the de minimis amount.

Senator DORGAN. And so that would only be a concern if someone described a system that is different than I have described.

LOUISIANA AND MICHIGAN PAPERLESS FILING PILOTS

Let me ask you, the two States that have adopted a pilot project on a return-free system, are they Michigan and Louisiana?

Mr. BURMAN. Yes.

Senator DORGAN. Often we find interesting things happening on a pilot basis in the State governments. And having been a State official, I can tell you there is some source of pride in the States because they are able to move a bit more quickly, they are a bit more flexible, they are not quite as muscle bound as we are at the Federal level.

So two States have now begun to move saying, at our State income tax level, we want to do a return-free system. Can you give me any information about what these States are doing and what their experience is?

Mr. BURMAN. My understanding is that Michigan enacted and actually implemented a pilot, a no-form option for wage earners,

which had a small, I think \$100 non-wage income exemption, \$200 for joint returns in 1996. The experience in Michigan suggests that you might need to do some outreach to employers. Our understanding, based on a phone call just a day or two ago was that they have actually suspended the program because there are only 128 people who are taking advantage of it.

They do not really know why, and that is what they are trying to find out right now. Their suspicion is that employers just basically do not want to take on the burden of trying to get withholding exactly right for their employees.

Louisiana enacted a program but they actually have not implemented it yet.

Senator DORGAN. But you understand that exact withholding is not so much a function of the employer as it is the withholding table described by the Internal Revenue Service. I have met with many employer groups, NFIB, the Chamber, and so on about this issue. The slight modifications in the W-4, and they are not significant, the slight modifications in the W-4, can be offset by some additional help to the businesses in the form of a tax credit for preparation and so on.

Mr. BURMAN. Your proposal does that.

Senator DORGAN. Yes, and my proposal has that. But the Internal Revenue Service would actually create the withholding table to say this is the exact withholding that is necessary given this salary and these checkmarks on the W-4. So it is not the employers responsibility and would add no burden to the employer with respect to the actual withholding computation or calculation.

Mr. BURMAN. The employer does need to know a little bit more information. They need to know the number of children, for example. Under your plan they would need to know whether that person was eligible for the child tax credit.

Senator DORGAN. That is correct.

You have described some numbers here. There are a group of people in this country whose sole income characteristic is largely wages. They do not have complicated incomes. They have a job, they go to work, they get paid a wage, and there is nothing very complicated with respect to their income situation. They do not have a lot of other income, perhaps hundreds, perhaps \$1,000 or \$2,000 of interest of capital gains, but very straightforward.

In those circumstances, where you do not have other kinds of peculiar issues, it is very easy to create a return-free system, is it not? Just in those circumstances?

Mr. BURMAN. Right, as long as they are not taking advantage of education credits, child dependent care tax credit, things like that.

ADVANTAGES OF SENATOR DORGAN'S PLAN

Senator DORGAN. When someone has a more complicated income picture, it can become very difficult if not impossible to create a return-free system. You would agree with that, as well?

Mr. BURMAN. There also is a complication created by the Earned Income Tax Credit, as I mentioned.

Senator DORGAN. That is correct.

Mr. BURMAN. The British do deal with that, but it requires additional reporting over the course of the year.

Senator DORGAN. Let me go through just a couple of charts in just a couple of minutes, if I might, because I did not describe this in full detail. I will just take about 2 or 3 minutes, because I think it is important to do.

The goals of a fair and simple tax system are no obligation to file a tax return for those who would qualify, to elect to choose this approach, no difficult calculations, no last minute searches for records, and no anxiety about major audits because there is really nothing to audit. If they have not defrauded, with respect to the information about children and so on, there is nothing to audit.

Who could participate, families earning up to \$100,000 with up to \$5,000 in other income. The advantage to this is it does provide tax-free income as a result of savings and investment, which I think nurtures exactly the right influences, and individuals \$50,000 and up to \$2,500 in other income.

In addition to that, the taxpayers who would use this would be taxed at a single rate of 15 percent. So you flatten the rate at the bottom. They are permitted, with adjustments in W-4, the standard deduction, personal exemptions, child tax credit, deductions for home mortgage interest and Earned Income Tax Credit.

They are exempt from Federal income taxes on other qualifying income, up to the level I have described. And they are exempt from the AMT and they are relieved of the marriage penalty because in this circumstance there is no marriage penalty.

One of the other advantages of this approach is there is no marriage penalty for anyone who elects to use this form of filing. Married filing jointly has exactly double the standard deduction.

CHANGES TO THE ALTERNATIVE MINIMUM TAX

And finally, those remaining under the current system, who have decided they could not elect this because their income characteristics do not fit this, they would be exempt from the AMT provided they earn \$1 million or less annually. The reason I propose this change is I was part of the group that in 1986 wrote the Tax Reform Bill. I was on the Ways and Means Committee at the time. We have too many people now caught in the Alternative Minimum Tax calculation that were never anticipated to be caught in that circumstance. This bill would create a \$1 million threshold.

We would provide a 50 percent tax credit, up to \$500 in tax preparer expenses for those that cannot elect to use this system, provided their returns are provided electronically. We will have their marriage penalty reduced by making the standard deduction for them double what it is for single filers, and they will be exempt from Federal income taxes up to \$1,000 in dividend and interest income.

These are simply additions that do not really have much to do with the FASST plan but say to those who cannot elect to use the FASST plan here are some other considerations that we think are valuable and useful.

As I indicated, when I introduced this legislation, Senator Gregg from New Hampshire will be a cosponsor and Senator Durbin, and we are looking for others, Mr. Chairman, but I will not impose that request at the moment.

Senator CAMPBELL. First you have to understand it.

COMPLEXITY OF THE TAX CODE

Senator DORGAN. It is a circumstance where, as I mentioned, people now in this country use 6 billion hours to calculate their income taxes, 6 billion hours, with a "B", and spend \$75 billion to comply with this system. I have already shown the graph of the pages of rules and regulations.

I would like to meet one living person in this country who understands the tax code. I am willing to bet there is no one on the face of the earth that understands the United States Internal Revenue Service Code. Certainly you do not, Commissioner, and you do not, Mr. Secretary, and I do not.

Mr. ROSSOTTI. I would not claim I do.

Senator DORGAN. My expectation is that you do not have one person working there that understands it all because we have created here in the Congress a labyrinth of laws and regulations, all from good intentions, but all in a way that has created a very complicated system.

And my hope and desire would be to say to the American people, at least for a good number of you, there is an alternative way to comply and to reduce the amount of paper and to follow the lead of some 30 other countries and say you can comply with your income tax responsibilities without having to file an annual return, using the withholding slightly adjusted as the exact liability.

Is it more of a rough justice system? Yes, it is because you are exempting certain other income up to \$2,500. But it is rough justice in a way that is advantageous to the taxpayer and also advantageous to those who do not want to kill any more trees for the purposes of creating tax returns to be filed and stuck in a vault somewhere.

Your testimony, I think, provides us with some additional information about considerations that ought to be evaluated with respect to processing and the administration of the code itself. I think that is valuable.

I would encourage you to continue to work as Congress has instructed you to work, to get to a return free system for as many Americans as we can. And as I introduce this legislation in Congress, with Democrat and Republican support, I hope it contributes to a discussion that will lead to some compromise approaches so that in the future tens of millions of Americans who now file an annual return April 15th will be relieved of that burden.

Mr. Chairman, thank you.

Senator CAMPBELL. Thank you. You have convinced me that when I was in college I should not have majored in P.E.

ADDITIONAL COMMITTEE QUESTIONS

Thank you for appearing today, Commissioner. I am sorry again that we had to hold you up, but we do certainly appreciate you waiting around a bit.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED BY SENATOR DORGAN

IRS STAFFING IN NORTH DAKOTA

Question. It is my understanding that the IRS reorganization efforts may change IRS staffing levels for walk-in customer service in North Dakota as well as the use of mobil units. Would you please provide details of these plans as well as their effect on current IRS staffing in North Dakota?

I have a paper which provides more detail on this and would appreciate your looking into this and getting back to the Subcommittee. (Paper was provided to the Commissioner separately).

Answer. The Modernized Internal Revenue Service (IRS) is being designed with emphasis on its customers. Although staffing numbers have not yet been finalized, the chart below addresses the issues in North Dakota and our proposed actions.

Recommendation	Action
Unnumbered (1st paragraph of recommendations). There is already one GS-14 branch chief working in North Dakota. We don't need additional GS-14 or GS-15 positions. We need field staff who do the work!.	To provide the greatest assistance, we decided to have at least one TEC territory in each state, which will be managed by a GS-15 TEC manager. We feel strongly about having a separate manager because of the importance of education and outreach in the new IRS. The TEC Territory Office will stand up by October 1, 2002. A Compliance Territory Manager will replace the GS-14 branch chief position currently in North Dakota.
Staff a dual position taxpayer education/communication at the GS-11 or GS-12 level.	SB/SE and W&I will each have communications and education functions (TEC and SPEC respectively) in North Dakota. TEC will have the following positions: one GS-07, three GS-12, two GS-13 and one GS-15 in Fargo; and will also have two GS-12 in Bismarck. This territory is scheduled to stand up by October 1, 2002. Until then, the St. Louis Office will service the taxpayers. SPEC will have two GS-13 Partnership Specialists in Fargo. This office is scheduled to stand up by October 1, 2001. Until then, the Minneapolis Office will service the North Dakota taxpayers.
Increase the Information Systems (IS) staffing for fiscal year 2001 by one.	We are still working on the final design, and will consider your comments before finalizing the staffing.
Need additional RO positions to cover western ND and be stationed at Grand Forks.	While we do not plan to add revenue officer (RO) positions in Grand Forks at this time, we will consider your recommendations as we finalize our staffing plans for the future. The current SB/SE design reflects a Compliance Territory for North Dakota, and includes employees in four posts-of-duty. Currently, there are revenue officer positions in the following posts-of-duty: Fargo (6), Bismarck (1), Dickinson (1), and Minot (1). Even though we do not plan to put an RO in Grand Forks, we will be adding a new position which will handle some duties of an RO (see Item #6).

Recommendation	Action
Hire two additional CSRs in Minot	Instead of hiring additional CSRs, we will provide service to Minot and Williston by a mobile van, one day a week at both locations throughout the year. These mobile units are self-contained, and have the ability to set up as stand-alone units at libraries, shopping centers, etc., or to set up displays at requested and/or pre-determined locations. The objective of the W&I Field Assistance design is to locate services within a reasonable commute of the taxpayers it serves who still require face-to-face contact with the IRS. These taxpayers are the low to mid-income individual income tax return (Form 1040) filers who require significant return preparation assistance, and who are in the young and middle age groups. W&I also plans to offer assistance with kiosks as well as the combination of traditional fixed sites and mobile units.
Hire one additional CSR in Grand Forks	Currently there is one CSR in Grand Forks. Early in fiscal year 2001, our plan calls for two Taxpayer Resolution Representative (TRR) positions in Grand Forks. The newly created TRR position will combine most aspects of the traditional walk-in assistor, the tax auditor, and limited duties of the revenue officer, thus providing a greater range of services in our walk-in offices and minimizing the need for referrals. When offices are fully staffed by TRRs, we will no longer require detailing compliance personnel to provide assistance during filing season. As discussed earlier, we will be analyzing the best method to service taxpayers at each location, but have not completed our analysis of Devils Lake.
Hire one additional CSR in Fargo	By the end of fiscal year 2001, our plan calls for six TRRs in Fargo, and service to both Jamestown and Wahpeton by mobile van one day a week each, throughout the year. Currently there are three Contact Representatives and two Tax Examiners in Fargo. On October 1, 2000, there will be four CSRs in Fargo.
Hire one additional CSR in Bismarck	The current CSR staff of one GS-08 will be maintained for Bismarck. Dickinson will be serviced by a mobile van one day a week, throughout the year. We will consider changes in the future depending on workload and budget availability
Hiring additional CSRs may justify having a walk-in manager.	W&I organization design calls for a GS-13 walk-in manager in Fargo. The Belcourt area will be serviced by a mobile van, one day a week, throughout the year. We plan to maintain the current staff of seven Customer Service/Taxpayer Service/Office Collection Representatives (CSRs/TSRs/OCRs) at stand up on October 1, 2000. By the end of fiscal year 2001, our plan calls for increasing the staffing to 13, and expanding the responsibilities and authority of the employees.

TAX RETURNS

Question. How many hours does the IRS estimate American taxpayers will spend this year in complying with the federal tax laws? What is the cost of the federal compliance?

Answer. The total estimated burden hours that taxpayers spend in complying with all IRS forms and regulations through the end of fiscal year 1999 is approximately 5.8 billion hours. We do not have an estimate of the cost of the federal compliance.

Question. How many 1040EZ forms does the IRS expect will be filed for this year. How many 1040A forms, and how many for 1040s?

Answer. As of June 2, 2000, we had received the following counts of Tax Year 1999 returns filed on paper: 10.7 million paper 1040EZ; 13.8 million paper 1040A; and 45.6 million paper 1040.

Question. How long does the IRS estimate it takes for a 1040EZ filer to keep records, learn about the law, prepare the forms, copy, assemble and send this form to the IRS? How about the 1040A, and the 1040?

Answer. The time estimates as published in the Tax Year 1999 instructions books are as follows:

	1040EZ	1040A	1040
Recordkeeping	5 min	1 hr., 11 min	3 hr., 15 min.
Learning about the law	1 hr., 34 min	2 hr., 42 min	2 hr., 39 min.
Preparing the form	1 hr., 47 min	4 hr., 31 min	6 hr., 22 min.
Copying, assembling, and sending the form to the IRS	20 min	35 min	35 min.
Total	3 hr., 46 min	8 hr., 59 min	12 hr., 51 min.

Question. How many pages are the instructions for the 1040EZ, the 1040A and 1040.

Answer. The 1999 Tax Year 1040 family tax booklets had the following page counts:

1040EZ	32
1040A (including the instructions for schedules 1 and 2)	68
1040 (not including any instructions for schedules)	72

Question. Because of this burden on filing, how many taxpayers use a paid tax professional to help prepare their tax returns?

Answer. Our reports show that 57 percent of taxpayers used a paid tax professional for Filing Season 2000.

Question. Of these estimated 127 million individual tax returns, how many will be filed in the traditional manner (i.e. on paper, through the mail)? How many will be filed electronically this filing season?

Answer. For 2000, we project 92.1 million paper returns and 35.3 million electronic returns will be filed.

Question. How many people does the IRS employ to process the non-electronically filed returns?

Answer. At filing season peak, there are approximately 30,000 people on roll in the submission processing function at the service centers.

Question. What proportion of your budget is dedicated to processing the non-electronically filed returns? How much does that cost?

Answer. Approximately 11 percent of the total budget is associated with processing non-electronic returns. That equals \$896.5 million.

Question. How many processing centers are there nationwide?

Answer. There are 10 service centers.

Question. I understand that some of these centers are very old and in need of repair. How much does it cost to operate all of these centers?

Answer. For this fiscal year, a total operating cost of \$204.4 million is designated.

CONCLUSION OF HEARING

Senator CAMPBELL. With that, this subcommittee is recessed.

[Whereupon, at 3:40 p.m., Thursday, April 13, the hearing was concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

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