

LESS IS MORE: THE INCREASING BURDEN OF TAXPAYER PAPERWORK

HEARING

BEFORE THE
SUBCOMMITTEE ON REGULATORY AFFAIRS
OF THE

COMMITTEE ON
GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

MAY 25, 2005

Serial No. 109-35

Printed for the use of the Committee on Government Reform



Available via the World Wide Web: <http://www.gpo.gov/congress/house>
<http://www.house.gov/reform>

U.S. GOVERNMENT PRINTING OFFICE

22-202 PDF

WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2250 Mail: Stop SSOP, Washington, DC 20402-0001

COMMITTEE ON GOVERNMENT REFORM

TOM DAVIS, Virginia, *Chairman*

CHRISTOPHER SHAYS, Connecticut	HENRY A. WAXMAN, California
DAN BURTON, Indiana	TOM LANTOS, California
ILEANA ROS-LEHTINEN, Florida	MAJOR R. OWENS, New York
JOHN M. McHUGH, New York	EDOLPHUS TOWNS, New York
JOHN L. MICA, Florida	PAUL E. KANJORSKI, Pennsylvania
GIL GUTKNECHT, Minnesota	CAROLYN B. MALONEY, New York
MARK E. SOUDER, Indiana	ELIJAH E. CUMMINGS, Maryland
STEVEN C. LATOURETTE, Ohio	DENNIS J. KUCINICH, Ohio
TODD RUSSELL PLATTS, Pennsylvania	DANNY K. DAVIS, Illinois
CHRIS CANNON, Utah	WM. LACY CLAY, Missouri
JOHN J. DUNCAN, JR., Tennessee	DIANE E. WATSON, California
CANDICE S. MILLER, Michigan	STEPHEN F. LYNCH, Massachusetts
MICHAEL R. TURNER, Ohio	CHRIS VAN HOLLEN, Maryland
DARRELL E. ISSA, California	LINDA T. SANCHEZ, California
GINNY BROWN-WAITE, Florida	C.A. DUTCH RUPPERSBERGER, Maryland
JON C. PORTER, Nevada	BRIAN HIGGINS, New York
KENNY MARCHANT, Texas	ELEANOR HOLMES NORTON, District of Columbia
LYNN A. WESTMORELAND, Georgia	
PATRICK T. McHENRY, North Carolina	BERNARD SANDERS, Vermont
CHARLES W. DENT, Pennsylvania	(Independent)
VIRGINIA FOXX, North Carolina	

MELISSA WOJCIAK, *Staff Director*

DAVID MARIN, *Deputy Staff Director/Communications Director*

ROB BORDEN, *Parliamentarian*

TERESA AUSTIN, *Chief Clerk*

PHIL BARNETT, *Minority Chief of Staff/Chief Counsel*

SUBCOMMITTEE ON REGULATORY AFFAIRS

CANDICE S. MILLER, Michigan, *Chairman*

GINNY BROWN-WAITE, Florida	STEPHEN F. LYNCH, Massachusetts
CHRIS CANNON, Utah	WM. LACY CLAY, Missouri
MICHAEL R. TURNER, Ohio	CHRIS VAN HOLLEN, Maryland
LYNN A. WESTMORELAND, Georgia	

EX OFFICIO

TOM DAVIS, Virginia

HENRY A. WAXMAN, California

ED SCHROCK, *Staff Director*

DENA KOZANAS, *Counsel*

LAUREN JACOBS, *Clerk*

KRISTA BOYD, *Minority Counsel*

CONTENTS

Hearing held on May 25, 2005	Page 1
Statement of:	
Everson, Mark W., Commissioner, Internal Revenue Service; and John D. Graham, Ph.D, Administrator, Office of Information and Regulatory Affairs, Office of Management and Budget	9
Everson, Mark W.	9
Graham, John D.	36
Steinberg, Leonard, the Steinberg Group; Keith Hall, Hall and Hughes, PLLC; and Larry Gray, Alfermann, Gray and Co.	58
Gray, Larry	77
Hall, Keith	68
Steinberg, Leonard	58
Letters, statements, etc., submitted for the record by:	
Everson, Mark W., Commissioner, Internal Revenue Service, prepared statement of	12
Graham, John D., Ph.D, Administrator, Office of Information and Regu- latory Affairs, Office of Management and Budget, prepared statement of	38
Gray, Larry, Alfermann, Gray and Co., prepared statement of	79
Hall, Keith, Hall and Hughes, PLLC, prepared statement of	70
Miller, Hon. Candice S., a Representative in Congress from the State of Michigan, prepared statement of	3
Steinberg, Leonard, the Steinberg Group, prepared statement of	60

LESS IS MORE: THE INCREASING BURDEN OF TAXPAYER PAPERWORK

WEDNESDAY, MAY 25, 2005

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY AFFAIRS,
COMMITTEE ON GOVERNMENT REFORM
Washington, DC.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2154, Rayburn House Office Building, Hon. Candice Miller (chairwoman of the committee) presiding.

Present: Representatives Miller, Lynch, and Souder.

Staff present: Ed Schrock, staff director; Dena Kozanas, counsel; Lauren Jacobs, clerk; Krista Boyd, minority counsel; Cecelia Morton, minority office manager.

Ms. MILLER. I would like to call the hearing to order. I welcome you all today.

We are here today to discuss the ongoing oversight of the Internal Revenue Service in its taxpayer paperwork burden reduction efforts, particularly in relation to the provisions under the Paperwork Reduction Act. Like paying taxes, paperwork is an inevitable part of an American adult's responsibilities. Each year, Federal agencies collect a variety of information from individuals. This information might be helpful for the agencies, but it can also be a huge nuisance for individuals and businesses.

For many individuals, tax paperwork is confusing and very time consuming. In 2001, the Joint Committee on Taxation released a study that stated individual taxpayers filing Form 1040 could encounter 79 lines on their return, 144 pages of instructions, 19 separate worksheets, as well as the possibility of filing numerous other forms.

For small businesses, the burden is equally troublesome. In 2001, the Small Business Administration Office of Advocacy released a report on the regulatory costs of tax paperwork compliance faced by small firms. At that time, they found that a typical small business faced a burden of over \$1,200 per employee, actually, to comply with tax paperwork, recordkeeping and reporting requirements.

Small businesses, of course, make up 99 percent of all U.S. business and employ over one-half of our American work force. Yet the tax compliance burden for them is more than twice that which is faced by large firms.

Paperwork burden is not a new problem. The desire to reduce it has long been recognized by this Congress and others before it. In fact, in 1980, the Congress enacted the Paperwork Reduction Act and established the Office of Information and Regulatory Affairs

within the Office of Management and Budget, whose primary responsibility is paperwork reduction. In 1986 and then again in 1995, Congress passed amendments to the PRA and set Government-wide paperwork reduction goals of 10 percent for fiscal years 1996 and 1997 and then a 5 percent reduction for each of the next 4 fiscal years, and annual paperwork goals thereafter that reduced burden to “maximum practical opportunity.”

Unfortunately, to this date, these goals have not been realized, and we certainly hope that today’s hearing will help us understand how the Congress can assist the agencies in achieving these goals. By the end of fiscal year 2001, these reduction goals would have placed the Government-wide burden at 4.5 billion hours. But these burden levels were a significant contrast to the mandated 35 percent reduction goal of 7.6 billion hours.

And now the burden is about 8 billion hours. Interestingly enough, one agency is accountable for 80 percent of this figure—of course, the Internal Revenue Service.

Information collected as part of the tax system is a principal ingredient in a very overstuffed pot of paperwork burden imposed by the Federal Government. Present estimates show that nearly 6.5 billion hours of paperwork burden is a result of the IRS. Even though the IRS accounts for 80 percent of the burden, it does not account for 80 percent of the information collections. In fact, the current estimates show that out of nearly 8,000 information collections Government-wide, IRS collections only account for approximately 800, which is roughly 10 percent. Of those 800 forms, only 10 are culpable for producing about 80 percent of the burden. Of course, the basic tax returns, Form 1040 and its associated schedules, measure at 1.6 billion hours or 24 percent of all IRS burden.

Certainly to be fair, much of the IRS challenge in reducing taxpayer burden is a complex Internal Revenue Code passed by Congress. However, the Code’s complexity also underscores the importance of creating tax forms and instructions that are as clear as possible and as understandable as possible. Moreover, even though a statute may require the IRS to take certain action, the agency does have the discretion in the manner and the frequency with which the information is collected, and even if it needs to be collected.

The IRS has taken its own initiatives to curb the rise in its paperwork burden. In 2002, the IRS created the Office of Taxpayer Burden Reduction. And the IRS has also expanded the E-government projects that it has by creating an interactive customer service link on the Web site, and increasing efforts for e-filing. Although the IRS administrative and E-government initiatives are a huge step in the right direction, it will certainly take much more to tackle this 6.5 billion hour goliath. So we’re hoping that today’s hearing will examine how Congress may need to make adjustments to the PRA to make significant changes to the burden.

I certainly look forward to working with all of you today and hearing the testimony of our witnesses. And at this time, I would like to yield to the ranking member, Representative Lynch, for his opening statement.

[The prepared statement of Hon. Candice S. Miller follows:]

**Statement of Chairman Candice S. Miller
Chairman
Subcommittee on Regulatory Affairs
Committee on Government Reform
Washington, DC
May 25, 2005**

Good afternoon, ladies and gentlemen.

We are here today to discuss ongoing oversight of the Internal Revenue Service in its taxpayer paperwork burden reduction efforts, particularly in relation to the provisions under the Paperwork Reduction Act.

Like paying taxes, paperwork is an inevitable part of an American adult's responsibilities. Each year federal agencies collect a variety of information from individuals. This information may be helpful for the agencies, but it can also be a nuisance to individuals and businesses. A perfect example of this type of agency is the IRS.

For individuals, tax paperwork is confusing and time consuming. In 2001, the Joint Committee on Taxation released a study that stated individual taxpayers filing Form 1040 could encounter 79 lines on their return, 144 pages of instructions, 19 separate worksheets as well as the possibility of filing numerous other forms.

For small businesses, the burden is equally troublesome. In 2001, the Small Business Administration, Office of Advocacy released a report on the regulatory costs of tax paperwork compliance faced by small firms. At that time, the typical small business faced a burden of over \$1,200 per employee to comply with tax paperwork, record keeping, and reporting requirements. Small businesses make up 99% of all U.S. businesses and employ over one-half of the American work force. Yet, the tax compliance burden for them is more than twice that faced by large firms.

Paperwork burden is not a new problem. The desire to reduce government burden has long been recognized by Congress. In 1980, Congress enacted the Paperwork Reduction Act and established the Office of Information and Regulatory Affairs within the Office of Management and Budget, whose primary responsibility is paperwork reduction. In 1986 and 1995, Congress passed amendments to the PRA and set government-wide paperwork reduction goals of 10% for fiscal years 1996 and 1997, a 5% reduction in each of the next 4 fiscal years, and annual paperwork goals thereafter that reduced burden to the "maximum practicable opportunity."

To this date, these goals have not been realized. By the end of fiscal year 2001, these reduction goals would have placed government-wide burden at 4.5 billion hours. But, these burden levels were a significant contrast to the mandated 35% reduction goal: 7.6 billion hours. Now, burden is about 8 billion hours. Interestingly enough, only one agency is accountable for 80% of this figure – the IRS.

Information collected as part of the tax system is the principal ingredient in an overstuffed pot of paperwork burden imposed by the federal government. Present estimates show that nearly 6.5 billion hours of paperwork burden is a result of the IRS.

Even though the IRS accounts for 80% of the burden, it does not account for 80% of information collections. In fact, current estimates show that out of nearly 8,000 information collections government-wide, IRS collections only account for approximately 800, which is roughly 10%. Of these 800 forms, only 10 are culpable for producing about 80% of the IRS burden. The basic tax returns – Form 1040 and its associated schedules – measure at 1.6 billion hours, or 24% of all IRS burden.

To be fair, part of the IRS challenge in reducing taxpayer burden is the complex Internal Revenue Code. However, the Code's complexity also underscores the importance of creating tax forms and instructions that are as clear and understandable as possible.

Moreover, even though a statute may require the IRS to take certain action, the agency does have discretion in the manner and frequency with which the information is collected, and even if it needs to be collected.

The IRS has taken its own initiatives to curb the rise in its paperwork burden. In 2002, the IRS created the Office of Taxpayer Burden Reduction.

The IRS has also expanded its E-Government projects by creating an interactive customer service link on the website and increasing efforts for e-filing.

Although these IRS administrative and E-government initiatives are a step in the right direction, it will take more than a piecemeal approach to tackle this 6.5 billion hour goliath. The IRS needs to satisfy the vision of the PRA by establishing creative and innovative approaches to reduce the burden on the American citizenry without relying on Congress to stop implementing tax-related measures.

And perhaps Congress needs to make some adjustments to the PRA to make significant changes to burden.

I look forward to working with you all on this.

**MEMORANDUM FOR MEMBERS OF THE GOVERNMENT REFORM
SUBCOMMITTEE ON REGULATORY AFFAIRS**

FROM: Candice S. Miller, Chairman /s/
DATE: May 17, 2005
SUBJECT: Briefing for May 25, 2005 Hearing, "Less is More: The Increasing Burden of Taxpayer Paperwork"

On Wednesday, May 25, 2005, at 2:00 p.m., in Room 2154 Rayburn House Office Building, the Government Reform Subcommittee on Regulatory Affairs will hold a hearing to consider ongoing oversight of the Internal Revenue Service in its taxpayer paperwork burden reduction efforts, particularly in relation to the provisions required under the Paperwork Reduction Act of 1980 (and as amended).

Paperwork Reduction Efforts

Like paying taxes, paperwork is an inevitable part of an American adult's responsibilities. Each year federal agencies collect an assortment of information from individuals in order to complete their agency's missions. Although such information collection may be beneficial for the agencies, it can have the unintended consequence of burdening individuals and businesses. Recent estimates show that government-wide paperwork burden hovers at 8 billion hours.

Paperwork burden is not a new phenomenon. The necessity to reduce government burden has long been recognized by Congress. In 1942, the Federal Reports Act established a review process where the Bureau of the Budget (currently the Office of Management and Budget (OMB)) decided whether information collection by a federal agency was necessary for the agency's proper performance. However, nearly 35 years later, Congress realized that the paperwork burden was consistently increasing and, as a result, the Commission on Federal Paperwork was created in 1977.

Due in large part to the Commission on Federal Paperwork's findings, Congress enacted the Paperwork Reduction Act of 1980 (PRA). The PRA continued to require all federal agency information collection activities to be subject to OMB review, but it articulated three chief purposes with regard to information collection: (1) to minimize federal paperwork burden for individuals, small businesses, state and local governments, and other persons; (2) to minimize the cost to the federal government of collecting, maintaining, using, and disseminating information; and (3) to maximize the usefulness of information collected by the federal government. To carry out this new mission, the PRA established the Office of Information and Regulatory Affairs within OMB. Commonly referred to as OIRA, this office is solely tasked with the oversight responsibilities of management of federal information resources, including paperwork reduction. Agencies must receive OIRA approval for each information collection request and those approvals must be renewed at least every three years. Alternatively, OIRA has the ability to disapprove any collection of information it believes is inconsistent with the PRA.

Though the PRA was a revolutionary piece of legislation in fighting the war on paperwork burden, statistics showed that burden was not decreasing any more than it had in previous years. As a result, Congress added minor amendments to the PRA when reauthorizing it in 1986. Additionally, Congress inserted more sweeping provisions during the reauthorization in 1995. The 1995 Amendments included the creation of a senior official position at each agency (currently referred to as the Chief Information Officer) to review agency information collections before submission to OMB. These amendments also mandated changes in federal paperwork reduction requirements. For example, the amendments required OIRA to set a goal of at least a 10% reduction in government-wide paperwork burden for fiscal years 1996 and 1997, a 5% reduction in each of the next 4 fiscal years, and annual paperwork goals thereafter that reduced burden to the “maximum practicable opportunity.”

Such stringent guidelines still did not reduce paperwork burden. By the end of fiscal year 2001, government-wide burden was estimated to be 7.6 billion hours, a significant contrast to the mandated 35% reduction goal in the 1995 Amendments which would have placed burden at 4.5 billion hours. Current estimates now set burden levels at about 8 billion hours. Interestingly enough, only one agency is accountable for 80% of this figure – the Internal Revenue Service (IRS).

Taxpayer Paperwork Burden: Role of the IRS

Information collected as part of the tax system is the principal ingredient in an overstuffed pot of paperwork burden imposed by the Federal government. Present estimates state that nearly 6.5 billion hours, or 80%, of government-wide paperwork burden is a result of the IRS. Even though the IRS accounts for 80% of the burden, it does not account for 80% of information collections. In fact, current estimates show that out of nearly 8,000 information collections government-wide, IRS collections only account for approximately 800, which is roughly 10% of the total. Of these 800 forms, only 10 are culpable for producing about 80% of the IRS burden. The basic tax returns – Form 1040 and its associated schedules – measure at 1.6 billion hours, or 24% of all IRS burden. Therefore, IRS paperwork burden is very concentrated.

In recent years, the IRS has made good-faith efforts in reducing paperwork burden. Most notably, in 2002, the IRS Commissioner established the Office of Taxpayer Burden Reduction. Among its accomplishments include certain threshold increases in an attempt to reduce burden. For example, by simply increasing the threshold of business expense on Form 1040, Schedule C-EZ from \$2,500 to \$5,000, the IRS was able to reduce taxpayer burden for 500,000 people by 5 million hours. Additionally, by increasing the threshold of Form 1040, Schedule B, the IRS was able to reduce the burden for 15 million people by 20.7 million hours.

Among the IRS’s other accomplishments include strides made in allowing individuals and small businesses to interface with the government electronically. For example, approximately 65% of federal individual tax returns have been filed electronically this year, business owners can request employee identification numbers on-line, K-1 forms can be completed electronically, and most customer questions can now be answered with the new “E-Services” link on the IRS website. With E-government initiatives high on the President’s Management Agenda, the IRS is apparently heeding the call of citizen-oriented reform.

Although these administrative and E-government accomplishments are noteworthy, unresolved issues still remain. Such issues include simplifying the extension to the filing process, the inability of complicated tax forms to be submitted electronically, costly software development, and fraud protection.

The IRS often insists that the enormous amount of paperwork burden attributed to it is a result of a complex Internal Revenue Code. The agency contends that but for a moratorium on legislative action to the tax code, it may not be able to reduce the amount of paperwork burden as envisioned by the PRA. However, even though a statute may require the IRS to take certain action, the agency does have discretion regarding whether paperwork requirements need to be imposed, and if so, the manner and frequency with which the information is collected.

The strides taken by the IRS are a step in the right direction, but piecemeal approaches to a 6.5 billion hour goliath is inadequate for the resources available. Innovative and effective solutions could be found in simplifying forms, using plain English in instructions, lengthening reporting periods, and further increasing threshold requirements. Such administrative proposals would reduce volumes of paperwork, not to mention increase compliance, and such simple changes would greatly benefit the small business community, particularly those small business owners who may not be tech-savvy.

Most notably, the 1995 Amendments to the PRA mandated an incremental reduction in burden each year for six years and a maximum practicable reduction in the years thereafter. As evidenced by the incremental increase instead of decrease over the past ten years, the IRS efforts at burden reduction fail to satisfy the goals envisioned by the PRA.

Witnesses

The invited witnesses for the May 25, 2005 hearing are: Mr. Mark W. Everson, Commissioner, Internal Revenue Service and former Deputy Director for Management, Office of Management and Budget; Dr. John D. Graham, Administrator, Office of Information and Regulatory Affairs, Office of Management and Budget; Mr. Leonard Steinberg, The Steinberg Group and former member of the Taxpayer Advocacy Panel, on behalf of the Small Business & Entrepreneurship Council; Keith Hall, Hall & Hughes, PLLC, on behalf of the National Association for the Self-Employed; and Larry Gray, Alferman, Gray & Co., on behalf of the National Association of Tax Preparers.

Mr. LYNCH. Thank you, Madam Chairwoman.

First of all, I want to begin by thanking you for your willingness to look at this issue. I want to thank Dr. Graham and Commissioner Everson for your willingness to come before the committee and help us out.

I do share in the spirit of this hearing in terms of the overarching goal of reducing the paperwork for U.S. taxpayers in this process. I do understand that sometimes the actions that we take as Members of Congress, we actually make that problem worse rather than help it. So I do not see it as your responsibility alone, I think it is a shared responsibility between we in the Congress and yourselves. You have just been given a more specific role in this, I think. I understand I'm not holding anyone here to blame for what we have been unable to do in the Congress, which is to sort of simplify the whole process on our end.

I am concerned, however, that while we go at this goal, and it is a laudable goal and we should stay at it, of reducing the paperwork and the time burdens on Americans who just want to file their tax returns and pay their tax obligations, while we're in this process, it seems that the progress is slow. Again, that is not your fault, it is our shared responsibility.

However, I do see across the country in various IRS offices, and because 80 percent of this, of the paperwork instituted by Government activity is the responsibility of the IRS or in their jurisdiction, that seems to be where we can realize the greatest gains, I guess, in our mission. I see that across the country we are reducing staff would who otherwise be available to help taxpayers either in call centers or in walk-in centers to help them with the process, which remains fairly complicated for the average taxpayer.

Until we can reduce this to a level where hopefully people can handle it on their own without professional help, I would like to express my concern about sort of a premature reduction in work force for those who would help taxpayers within the IRS grapple with the forms and with the whole process.

But I do appreciate both of you coming before us and working on this problem. I think this is a bipartisan effort. That is the way we approach it here in terms of a mutual goal, shared by both Republicans and Democrats here in the Congress.

Thank you, Madam Chairwoman.

Ms. MILLER. Thank you. If I could just remind the witnesses, in the interest of time here, we try to keep your oral comments to about 5 minutes. In fact, you've got these little boxes in front of you, when you see the yellow light it shows you have 1 minute remaining, then the red light of course, says that 5 minutes is up. If you are still speaking at that time, just try to wrap it up if you could.

It's the process of our committee here that we swear in all of our witnesses, so if you could rise, please, and raise your right hands.

[Witnesses sworn.]

Ms. MILLER. Thank you very much.

Our first panelist today is Commissioner Mark W. Everson. He is the Commissioner for the Internal Revenue Service, of course. Commissioner Everson was actually confirmed in May 2003. Prior to coming to the IRS, Commissioner Everson served as the Deputy

Director of Management for the Office of Management and Budget. He is the 46th Commissioner of the IRS.

Commissioner Everson, we want to thank you very much for attending the hearing today. We look forward to your comments, sir.

STATEMENTS OF MARK W. EVERSON, COMMISSIONER, INTERNAL REVENUE SERVICE; AND JOHN D. GRAHAM, PH.D, ADMINISTRATOR, OFFICE OF INFORMATION AND REGULATORY AFFAIRS, OFFICE OF MANAGEMENT AND BUDGET

STATEMENT OF MARK W. EVERSON

Mr. EVERSON. Madam Chairwoman, Mr. Lynch and members of the subcommittee. Thank you for the opportunity to testify on the Internal Revenue Service's continuing efforts to reduce unnecessary paperwork burdens on the taxpayer.

As this committee well knows, individuals and businesses spend more than 6 billion hours a year on tax paperwork and other tax challenges. Together, the Internal Revenue Code and regulations run for millions of words. In terms of pages, that is twice as many pages as 20 years ago.

Burden is a direct result of the complexity of the Code. Not only does complexity cause economic burden, it also obscures understanding. Complexity in the Tax Code compromises both our service and enforcement missions. Taxpayers who seek to comply but cannot understand their tax obligations may make inadvertent errors or may ultimately throw up their hands and say, why bother?

In the enforcement context, complexity facilitates behaviors at variance with those intended by Congress. Our goal is to impose the least amount of burden necessary for taxpayers to meet their tax responsibilities.

A certain amount of paperwork, of course, is essential to tax collection. Taxpayers must report what they make to the IRS. Their incomes and businesses can be complex. Their deductions and credits can be complex. So the paperwork can be complex. That having been said, we seek to reduce unnecessary paperwork and make the filing process as simple and convenient as possible.

The Office of Taxpayer Burden Reduction at the IRS has aggressively pursued burden reduction initiatives. Since the Office was launched in January 2002, we have reduced taxpayer burden by over 200 million hours. One area of our initiatives involves filing thresholds. We recently increased the Federal unemployment tax deposit threshold from \$100 to \$500, reducing burden for over 2.6 million employers.

We also increased the threshold for filing Form 1040EZ and Form 1040A from \$50,000 to \$100,000, decreasing taxpayer burden by more than 5 million hours. And for small businesses, we increased the threshold for business expenses reported on Form 1040CEZ from \$2,500 to \$5,000. This enabled about 500,000 more taxpayers to file this simpler form.

We are also working to reduce burden through other means. For example, we are simplifying forms and instructions. We simplified the Schedules K-1 for partnerships and S Corporations, reducing burden by an estimated 95 million hours for the 20 million taxpayers who file these forms. In addition, we are actively consider-

ing allowing very small employers to file their employment taxes returns annually instead of quarterly. We estimate that this action alone could reduce burden on approximately 1 million businesses by some 50 million hours.

The revolution in electronic filing also helps to reduce the paperwork burden. Electronic filing of taxes requires less paper and is more accurate. Computers catch mistakes that would have been made on paper and required more time to correct. This year for the first time more than half of all individual taxpayers have filed electronically. Starting next year, we have mandated that all larger corporations file electronically. This will reduce significant amounts of paperwork and speed up audits.

Congress has a key role to play in reducing the paperwork burden. Dealing with complexity and paperwork is easier if the Tax Code is stable. But tax laws change quite frequently. I'm sure you saw this last week, but take for example the Jobs Act that you passed last year. It brings important benefits to the economy and does much to strengthen the Government's hand in combating abusive shelters. But it also adds complexity to the Code. The Jobs Act has 193 provisions, 178 of these require IRS actions like the issuance of guidance, and the creation of new forms.

Before I close, let me briefly discuss tax reform, the real opportunity for significant simplification and burden reduction. Earlier this year, the President created a bipartisan panel to examine ways to "simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws." In March, I appeared before the panel and made five suggestions concerning tax reform.

First, our economy is constantly evolving with change seemingly ever-accelerating. Examples of change include transformation of the work force to more self-employed individuals, businesses contracting out activities they had previously done themselves, the relatively greater portion of economic growth generated through smaller, non-manufacturing businesses and increasing globalization. It is vital to construct a tax system that recognizes this dynamic and is built for the 21st century, not the 1960's.

Second, policy options should be carefully assessed for their potential impact on attitudes toward compliance. Fairness and a perception of fairness are essential, as the President has recognized in his charge that the reform proposals be "appropriately progressive."

Third, administerability is also an important consideration. Bolt-ing on new programs to the Tax Code without significantly simplifying or eliminating existing elements may in fact make it more difficult to collect the \$2 trillion we need to fund the Government. Fourth, there needs to be an apples to apples comparison. We should not compare a sub-optimized existing system to a perfect theoretical system. I can assure you from my conversations with counterpart tax administrators that there are administrative and compliance issues in all systems.

Finally, we must recognize the transitions issues associated with migration to a new system or systems merit close attention. If the transition is not properly planned and managed, the new system will get off to a rocky start. After such a start, it may take decades to recover.

I wish to emphasize that these points are not offered to suggest inaction. That would be perhaps the worst option. I strongly support the President's call for simplification. Simplification is essential to burden reduction. Thank you.

[The prepared statement of Mr. Everson follows:]

**WRITTEN STATEMENT OF
MARK W. EVERSON
COMMISSIONER OF INTERNAL REVENUE
BEFORE THE COMMITTEE ON GOVERNMENT REFORM'S
SUBCOMMITTEE ON
REGULATORY AFFAIRS
UNITED STATES HOUSE OF REPRESENTATIVES
HEARING ON
PAPERWORK BURDEN REDUCTION
May 25, 2005**

Madam Chairman, Mr. Lynch, and Members of the Subcommittee, thank you for the opportunity to testify on the Internal Revenue Service's continuing efforts to reduce unnecessary taxpayer burden.

We remain firm in our commitment to impose the least amount of burden necessary for taxpayers to meet their tax responsibilities. The IRS Strategic Plan, outlining our vision for 2005-2009, is very clear in articulating this goal and making its achievement the responsibility of each and every IRS employee. In spite of our continuing efforts, reducing taxpayer burden and helping taxpayers understand our very complicated and ever changing tax code remains a formidable challenge. As the President noted when he announced the establishment of the Advisory Panel on Tax Reform: "For millions of Americans, the annual rite of filing taxes has become a headache of burdensome record-keeping, lengthy instructions, and complicated schedules, worksheets, and forms-often requiring multiple computations that are neither logical nor intuitive." One of the Panel's goals is to "simplify Federal tax laws to reduce the costs and administrative burdens of compliance with such laws."

IRS Burden Reduction Challenges

Although we are taking aggressive action to diminish taxpayer burden, we fully expect that, without fundamental tax reform, the aggregate burden taxpayers face will continue to grow. Part of this growth is systemic in that it is simply the result of more people filing tax returns each year.

In addition to systemic growth, burden increases as a result of added complexity because of changes in the tax law. Year after year, as Congress passes new legislation, taxpayer burden is increased. Frequent changes to the Code and the complexity of the tax law are the greatest obstacles to overcome as we work to reduce unnecessary taxpayer burden. This growing complexity of the tax law is illustrated by the increase in the number of pages in the CCH Standard Federal Tax Reporter (Reporter), which includes the Code, Treasury Regulations, and IRS rulings. In 1974, the Reporter was 19,500 pages. In 2005 the page count has more than tripled, to 61,000 pages.

Our tax system relies upon voluntary self-assessment of tax liability by taxpayers. Increasing complexity hinders the ability of average American citizens to assess their tax liability, and may serve as a disincentive for taxpayers to comply with their tax obligations. Moreover, the increasing complexity of our tax laws hinders our ability to provide American taxpayers with the service they deserve.

Distinguishing Between “Necessary” and “Unnecessary” Taxpayer Burden

Tax administration comprises approximately eighty percent of the overall paperwork burden imposed by the federal government. But, that number can be somewhat misleading because much of the burden is the result of action taken by the IRS that is necessary to implement legislation. The IRS creates forms that enable taxpayers to comply with the law. A good analogy is that the forms are a bridge between taxpayers and the tax law, enabling citizens to comply in a consistent manner. That being said, we are committed to eliminating unnecessary burden by making our forms, schedules, publications, processes, procedures, and communications as clear and simple to understand as possible. Note that a significant part of a businesses’ paperwork burden is associated with recordkeeping and financial requirements inherent in conforming to good business practices, regardless of tax-reporting requirements. When we measure the burden from taxes, we do not include such foundational burden that would exist without taxes.

Impact of Recent Legislation

While new tax legislation often provides worthwhile new benefits or incentives for taxpayers, the tradeoff is often additional complexity and increased burden. Let me provide you with a good example of how new legislation can increase taxpayer burden and how the IRS seeks to reduce any associated unnecessary burden. The Working Families Tax Relief Act of 2004 required revisions to 154 tax products (tax forms, instructions, and publications). The American Jobs Creation Act of 2004 will require revisions to, or the addition of, 174 tax products before it is fully implemented. This includes ten new forms, two that have already been released and eight that are in development. Taxpayers’ paperwork burden will increase based on these new reporting requirements. However, the IRS continues to provide ways to help taxpayers file accurate and timely tax returns to reduce unnecessary burden. For example, the American Jobs Creation Act includes a provision for taxpayers to elect to deduct state and local sales taxes or state and local income taxes as an itemized deduction. This provision is especially beneficial to taxpayers residing in states with no income tax. The IRS developed a new Publication 600, Optional State Sales Tax Table, which includes tables, based on income and family size, to help taxpayers determine their allowable state sales tax deduction without having to collect sales receipts for all applicable purchases. In addition, for taxpayers in Alaska, with 89 local tax jurisdictions, the IRS developed a new Publication 600-A, to address their special needs.

Burden Reduction Process

Over the last several years, we have developed a number of processes that provide opportunities to reduce burden without compromising our regulatory objectives. We have opened a dialogue with numerous external stakeholders including taxpayers, practitioners, citizen groups, industry groups, software developers, and state and federal agencies to receive suggestions for reducing unnecessary taxpayer burden. We have regularly met with the Department of the Treasury, the Office of Management and Budget (OMB), the Government Accountability Office (GAO), and the Small Business Administration (SBA). These discussions are very important because they advance the burden reduction dialogue. We have developed comprehensive strategies to effectively communicate the delivery of programs designed to reduce burden. Over the last year alone, we have communicated to taxpayers about our many programs focused on reducing and simplifying forms, publications and notices, and promoting less burdensome rulings, regulations, and law. For example, this year as part of the redesign of Form 941, Employer's Quarterly Federal Tax Return, we developed and implemented a cross-functional communications plan that began with sharing a draft revision with external stakeholders to ensure it achieved our goals for simplification, and ended with an outreach strategy to ensure tax professionals, taxpayers, and IRS employees made a smooth transition to the new form.

Here are a few of the institutionalized vehicles we used to solicit ideas from the public and third party stakeholders:

- Form 13285A, Reducing Taxpayer Burden on America's Taxpayers was created so the public could participate in identifying taxpayer burden reduction. This form provides taxpayers with a process for submitting ideas for consideration directly to the Office of Taxpayer Burden Reduction. The form is available on [irs.gov](https://www.irs.gov).
- The Industry Issue Resolution (IIR) program was created to give taxpayers, industry associations, and other interested parties a vehicle for submitting burdensome business tax issues for possible resolution through published or administrative guidance. The goal is to quickly resolve tax issues that are common to a significant number of business taxpayers by providing targeted guidance on specific tax issues. Under the program, the IRS has issued guidance that has reduced costs, burden, and uncertainty for taxpayers.
- Practitioner and Small Business Forums with national and local level tax professionals and small business associations provide an opportunity for external customers to share feedback on burden reduction initiatives before they are implemented. These forums also provide a means for identifying and resolving issues of burden and communicating initiatives as they become available.
- The Information Reporting Program Advisory Committee (IRPAC) and the Internal Revenue Service Advisory Council (IRSAC) both play a significant role as external evaluators regarding burden reduction initiatives. Both groups advise the IRS on our initiatives on a regular basis.
- The Taxpayer Advocacy Panel consists of citizen volunteers from all fifty states and acts as a two-way conduit serving, among other important roles, as a focus group for the IRS by providing input on strategic initiatives, as well as providing a

venue for raising issues identified by citizens. This panel is also routinely called upon to make suggestions and to identify ways to reduce taxpayer burden.

- Our Fed/State program has worked in close partnership with state and federal agencies to reduce burden. For instance, the Federation of Tax Administrators, which represents taxing agencies nationwide, is regularly called upon to vet ideas and to provide input.

To further promote burden reduction, we use established national and local networks to ensure we disseminate important information about these important programs as broadly as possible. All of the vehicles mentioned above are fully engaged in this delivery. In addition:

- IRS News Releases and SB/SE Headliners announcing burden reducing initiatives are sent through media channels, including small business and trade publications.
- Practitioner Institutes serve as part of an overall practitioner education curriculum that includes nationwide Tax Forums, liaison meetings, and Tax Talk Today, a monthly program about current tax issues and policies. The Institutes provide a much-needed venue for delivering burden reducing initiatives to those who prepare countless tax returns for the public each year.
- Small Business Tax Workshop materials developed by the IRS are delivered to taxpayers through educational institutions across the country. Public notices of available workshops are posted on irs.gov. For those interested in a self-directed workshop, the On-Line Classroom, a video streaming of a Small Business Tax Workshop, is available. These materials are routinely updated to include burden reducing initiatives.
- The Small Business Resource Guide CD, a one-stop tax information/management tool, is also updated annually to include burden reduction efforts.

We also make a concerted effort to engage IRS employees in suggesting and implementing burden reduction strategies. It is important to note that most of the significant taxpayer burden reduction initiatives require a considerable commitment of our resources to accomplish. Systems must be reprogrammed, processes must be changed, and personnel must be trained. Taxpayers, practitioners, federal and state agencies, and software developers must be included in the process so that changes are as open, transparent, and helpful as possible.

The Office of Taxpayer Burden Reduction

In 2002, the Service established the Office of Taxpayer Burden Reduction (OTBR) to lead cross-Service burden reduction efforts. Since its inception, that Office has aggressively pursued reduction initiatives and enabled the IRS to reduce burden by more than 200 million hours. OTBR has reduced burden by focusing on simplifying forms, publications, and notices; streamlining internal policies, processes, and procedures; promoting less burdensome rulings, regulations, and law; assisting in the

development of a burden reduction measurement methodology and model; and partnering with internal and external stakeholders to more effectively and efficiently identify and address burden reduction initiatives.

Since last year's hearing, OTBR has made progress in leading the IRS in a number of initiatives, and as a result of their efforts:

- We increased the threshold for Forms 1040EZ and 1040A filers from \$50,000 to \$100,000, enabling more than 1 million additional taxpayers to file Form 1040EZ or 1040A instead of a long Form 1040, and reducing their burden by more than 5 million hours (effective for tax year 2004).
- We increased the Form 1040 Schedule C-EZ business expense threshold from \$2,500 to \$5,000, enabling approximately 500,000 additional taxpayers to file a Schedule C-EZ instead of the regular Schedule C, and reducing burden for more than 1 million taxpayers by more than 5 million hours (effective for tax year 2004).
- We increased the Federal Unemployment Tax (FUTA) deposit threshold from \$100 to \$500, and reduced 3.2 million hours of burden for 2.6 million taxpayers (beginning in January 2005).
- We simplified Schedules K-1 for Partnerships and S Corporations and the related instructions to reduce common errors and the burden associated with preparation and filing (effective for tax year 2004). The simplified schedule will reduce approximately 95.1 million hours of burden for the over 20 million taxpayers who receive Schedule K-1, used to report income, deductions, and credits from partnerships and small corporations. These changes should result in fewer pre-filing preparation errors and fewer unnecessary post-filing notices.
- We redesigned the Form 941, Employer's Quarterly Federal Tax Return, to make it easier for the 6.6 million employers who file 23 million of the Forms 941 a year to understand and complete (effective for the 2005 tax year). The new form features a significantly improved layout, with plain language instructions. Cognitive testing, as well as focus testing, was conducted to obtain external feedback prior to finalizing the design. The form is also scannable to decrease the risk of transcription errors.
- We have made significant progress in designing a simplified process for requesting filing extensions. The overall goal is to lessen the burden associated with applying for an extension and to create efficiency in processing extension applications. The new process will be in place in January 2006, to handle the 2005 tax year extension applications. We will consolidate 6 forms into 2, rendering 4 of these forms obsolete. The surviving Form 4868 for individuals and Form 7004 for businesses will be simpler and take less time to prepare. The new process will take taxpayers less time to complete, reduce the potential

for incorrect form submission, and result in less taxpayer contact. Additionally, the business extension will have a format that is e-file compatible to allow approximately 1 million non-corporate entities to e-file extension requests. These changes should save taxpayers 9 million hours. We are also expanding the concept of simplification to estate and gift Form 4768 for taxpayers filing a request for extension to file and pay the related transfer tax.

- We have begun the redesign of the 2005 Schedule K-1, received by trust and estate beneficiaries and used to report income, deductions, and credits on their income tax returns. The format will be changed to resemble the redesigned 2004 Schedules K-1 for partners and shareholders, making it easier for taxpayers to determine where to report amounts from the Schedule K-1 on their income tax returns. The schedules were simplified to reduce common errors and the burden associated with preparation and filing requirements. The schedules are scannable, eliminating the risk of transcription errors. The instructions are also streamlined. The redesign incorporates input from the tax professional community, public comments, and focus groups. We project that the changes will decrease 4.3 million hours of burden for 3.5 million taxpayers.
- We have made considerable progress in establishing an annualized Form 941. Beginning in January 2007, eligible taxpayers will file annual Form 944 rather than quarterly Forms 941 (for taxable period January 2006 through December 2006). The project, which originated with plans to help in-home day care providers, targets taxpayers who owe \$1000 or less per year in total employment tax liability. Annualizing Form 941 (i.e., the new Form 944) offers small businesses significant burden reduction in that taxpayers can file a single return rather than four returns per year (i.e., 1,152,510 returns vs. 4,610,040 returns due currently, i.e., 3,457,530 fewer) and they will make a single payment with their returns. Taxpayer burden will be reduced by approximately 46 to 51 million hours.
- We are also progressing with our redesign of the Form 940, Employer's Annual Federal Unemployment Tax Return, and its associated processes to reduce the burden placed on 5.6 million taxpayers annually (effective for tax year 2006). We will be revising Form 940, 940EZ and 940PR, revising all related instructions, and ensuring optical scanning of the new form in the 2007 processing season.
- Further out on the horizon, we are developing a plan to create a new Form 94X to amend Forms 941, 943, 944, and 945 (effective 2008).

Reducing Prefiling Burden

If we can eliminate confusion and errors before a return or form is ever filed, taxpayers will be spared numerous unnecessary communications and burden. To achieve this goal, we created dedicated taxpayer education and prefiling organizations, as well as prefiling tools to help taxpayers better understand their responsibilities without imposing

undue burden. We have built into all of our business divisions the principle of working with taxpayers and industry groups before they file their returns. We have also dedicated our efforts to create administrative thresholds and safe harbors to minimize recordkeeping.

The IRS has one of the most rigorous paperwork review processes in the Federal government. In contrast to most information collections, which are generally subject to the Paperwork Reduction Act (PRA) process every three years, most IRS forms are subject to the PRA process on an annual basis. For example, all annual tax returns (such as IRS Form 1040 and its schedules and attachments) have been reviewed annually under the PRA for the past 25 years. This continuous analysis and review of tax forms over the years has, we believe, resulted in tax forms that comply fully with statutory standards.

In addition to the changes to the thresholds and forms I previously mentioned, we revised other forms and instructions to reduce taxpayer burden including:

- In 2004 Form 8862, Information to Claim Earned Income Credit After Disallowance, was significantly simplified. We reduced the number of questions asked and, as a result, the form and instructions are two pages instead of four pages. The average total time for completion was almost cut in half, resulting in 1.1 million fewer hours of paperwork for about 1 million taxpayers.
- New Schedule D, Form 941, for Reconciliations was developed for the first quarter of 2005. The schedule is used for reconciliation of employment taxes after statutory mergers, acquisitions, consolidations, etc. The new schedule allows filers to reconcile discrepancies when the Form 941 is filed so that follow up contacts by the IRS are reduced.
- The 2004 instructions for Form 4562, Depreciation and Amortization, were revised. Editorial changes were made throughout the form and instructions to simplify the instructions. Taxpayer burden was reduced by 22.4 million hours.
- In 2004, Form 1023, Application for Tax Exemption Under Section 501(c)(3) and application package were redesigned to ensure that all information needed to make an accurate determination of exempt status is available to the IRS when the application is filed. The redesigned form eliminates redundant reporting and separate forms, consolidates questions and financial data, highlights key words and provides a checklist, among other improvements.
- The instructions for Form 2848, Power of Attorney and Declaration of Representative, were revised in 2004 to reflect new regulations. They now allow representatives to use the same procedures as taxpayers for revoking an existing power of attorney. Also, the Form 2848 may now be filed electronically.

- o Effective April 14, 2005, we announced that employers will no longer be required to send copies of potentially questionable Forms W-4, Employee's Withholding Allowance Certificate, to the IRS. In the past, employers had to send to the IRS any Form W-4 claiming more than 10 allowances or claiming complete exemption from withholding if \$200 or more in weekly wages was expected. Rather than require all employers to continue this practice, the IRS will review situations on a case-by-case basis to determine if an employer should withhold income tax from an employee at a more appropriate rate. Additionally, the Office of Taxpayer Burden Reduction is studying the feasibility of simplifying the Form W-4 to reduce burden.

Reducing the Burden Associated with Compliance Actions

Accomplishments Aimed at Simplifying Notices

The IRS continues to redesign and simplify taxpayer notices. Since last year, we have made improvements to notices affecting of 25.5 million mailings. We simplified eight notices sent to taxpayers to remind them of a balance due. We added tax return line numbers to the remaining paragraphs that are included in math error notices to explain why we changed a taxpayer's account. This issue has been on the Top 20 Problems list of the National Taxpayer Advocate for several years. We simplified two Earned Income Tax Credit notices sent to taxpayers to help determine their eligibility. The redesigned CP 2000, used to address underreporting situations, received an award from the Washington, D.C., Chapter of the Society for Technical Communication. These successes in improving notices are the result of feedback from surveys of taxpayers, and testing high volume, sensitive notices with taxpayers before putting them in production.

Shortening the Duration of Compliance Activities

Recognizing the considerable time, money, and anxiety associated with the length of time it takes from the time a tax return is filed to the resolution of an issue with the IRS, or cycle time, as we call it, we have a number of initiatives to shorten time frames.

Alternate Dispute Resolution

We have a number of programs that embrace alternative resolution strategies as a means of shortening cycle time. Just one example is the Industry Issue Resolution (IIR) Program.

The IIR Program was designed to resolve business tax issues where the tax treatment is uncertain, frequently disputed, or burdensome and affects a significant number of taxpayers. Under the program, tax issues are identified by industry associations or others representing both Large and Mid-size Business (LMSB) and Small Business / Self-Employed (SB/SE) taxpayers and submitted to the IRS. Issues submitted are screened at least semi-annually to determine if an IIR project should be started. For each issue selected, an IIR team consisting of IRS and Treasury personnel meets with

taxpayers or other interested parties affected by the issue. The team's goal is to recommend clear guidance that business taxpayers can use, thus, reducing the burden, time and expense associated with resolving issues on a case-by-case basis during tax examinations. Since its inception, sixteen IIR projects have been completed.

Examination Reengineering

Our SB/SE Field Examination processes have been redesigned to shorten the time it takes between the time a taxpayer files his or her return and the time an examination is concluded. Once a return has been selected for examination, the process for that examination has been redesigned to reduce taxpayer burden by placing added emphasis on planning, documenting, analyzing risk and communicating. These four concepts, when brought together in the examination process, produce an efficient, less-intrusive, and quality audit. From the onset of the audit, the taxpayer is informed of the issues to be examined. This reduces the areas of concern for the taxpayer and reduces the documentation required.

We have also improved the front end process of selecting and classifying returns for examination, reducing the number of returns that are selected for audit that are in substantial compliance.

Improvements are not confined to SB/SE Field Revenue Agents. The Form 4549 Report (Income Tax Examination Changes) and Form 886-H, Explanation of Items (request for supporting documentation) used in correspondence examinations have been re-written to make them more understandable. These forms were redesigned in response to feedback we received from our customers who found the old forms confusing. We are eliminating the need for taxpayers to call us, because we found many of the phone calls to our examination teams were simply requests for an explanation of what the forms meant.

Additionally, LMSB has designed the Limited Issue Focused Examination (LIFE) process to reduce taxpayer burden by eliminating mandatory compliance checks and limiting the examination to the most material issues (after a full and robust risk analysis is performed). The result is a reduction in the number of hours required to perform the examination and a reduction in the length of time to complete the examination. Taxpayers tell us they have experienced burden reduction from the LIFE process, and our tracking supports that conclusion.

LMSB recently began a pilot known as Compliance Assurance Process, or CAP, to resolve examination issues upon the filing of the return on a real time basis. CAP is an effort to gauge whether an alternative approach to compliance that allows the IRS to work with corporate taxpayers prior to filing can shorten what are now lengthy post-filing audits.

Other Taxpayer Burden Reduction Accomplishments

The IRS has a number of initiatives that are in various stages of implementation that will reduce burden by helping us respond to taxpayers' inquiries about their accounts, improve telephone service, and facilitate timely responses to taxpayer correspondence.

- The Desktop Integration System (DI) will provide an IRS call center assistor with access to various IRS systems to determine the status of a taxpayer's account rather than transferring the taxpayer to another office where the account is being worked. This system will reduce the amount of time needed for account resolution and reduce the associated stress for the taxpayer. In addition, this system will allow an assistor to provide timely, quality responses to taxpayer correspondence by lessening the number of communications made to the taxpayer for additional information.
- The Correspondence Imaging System (CIS) improves the quality of customer service by providing on-line access to images of taxpayer correspondence, which aids in the efficient resolution of subsequent phone and written inquiries. Taxpayers are able to obtain information about their accounts accurately, quickly, and conveniently when interacting with Customer Service Representatives. The automated issuance of timely interim letters reduces taxpayer burden by eliminating a reason for second correspondence on a case. This system should benefit taxpayers by decreasing the overall time spent resolving cases. More than 10 million cases are received and worked each year. When fully implemented, the project forecasts that 11.2 million cases per year will be processed through CIS based on FY 2004 receipts.
- Contact Recording provides the technology to record customer contacts (audio & screens) and, based on business-defined rules, deliver them to managers and reviewers for quality review purposes. This enables employees to receive practical feedback and enhances their ability to accurately answer customer inquiries and save time for taxpayers by reducing repeat calls because of wrong answers. Approximately 36 million calls were handled by IRS Call Center assistors in fiscal year 2005 that will be impacted by this initiative.
- The Remittance Transaction Research Project will increase quality of service to taxpayers through early resolution of misapplied payments to taxpayer accounts because images of vouchers and checks will be available for on-line research. This initiative will reduce taxpayer burden because imaged checks and vouchers are available to assistors so that taxpayers are no longer required to provide a copy of their cancelled check. Approximately 3.5 million taxpayers are impacted annually by this initiative.
- Queuing Management Release 1, deployment of the Q-Matic equipment, will reduce taxpayer burden by providing an automated means to route customers to a specific assistor with the appropriate skill set and/or language to resolve

the contact. Q-Matic equipment has been deployed to 87 percent of the Taxpayer Assistance Centers Service-wide.

- o The Correspondence Examination Automation Support (CEAS) solution is being developed to process data more efficiently and quickly in order to handle more cases. Correspondence examinations are employed when the IRS requires specific documentation from the taxpayer to support the tax liability or credit. Many returns share the same non-compliance issues, resulting in systematic adjustments and form letters to the taxpayer. Automating this process allows the IRS to increase timeliness and accuracy of examinations, and allows more time to deal with questions raised by taxpayers during the audit.

Reducing Filing Burden (E-File Initiatives)

Electronic Tax Administration (ETA)

The benefits of electronic filing are clear and compelling. Taxpayers find it more convenient and economical and less time-consuming to do business electronically than sending paper through the mail. Other benefits of electronic filing include faster refunds, increased accuracy of returns, and acknowledgement of receipt of the e-filed return.

Significant challenges remain in transitioning from a paper-based environment to an electronic-based environment. The IRS developed an E-Strategy for Growth which outlines the IRS' plans to reduce taxpayer burden. To achieve the strategic goals, the IRS will develop and implement e-file marketing strategies, continue to expand the use of electronic signatures, and enhance IRS web site services for both practitioners and taxpayers. Ultimately, the goal of the Service is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

Taxpayers who transmit their Form 1040 tax returns electronically give high marks to the IRS' electronic filing programs. The American Customer Satisfaction Index (ACSI) shows customer satisfaction scores for IRS e-file exceed the averages for both the Government and retail sectors and rival those of the financial services sector. For electronic tax return filers, the overall ACSI rating is 78 percent. This surpasses the rating among paper return filers and the Government-wide satisfaction rating of 72.1 percent. Customer satisfaction and burden reduction initiatives are fundamental to the IRS' continued efforts to maintain taxpayer trust and compliance. The present e-filing system has demonstrated measurable success with regard to individual taxpayer satisfaction.

From its modest beginning as a pilot program in 1986, when 25,000 returns were filed electronically, the number of e-filed returns has dramatically increased, with more than

61 million returns filed electronically last year. In 2005, IRS expects over 68 million taxpayers to take advantage of the many benefits of electronic filing. These include:

- **Faster refunds:** Direct deposit can speed refunds to e-filers in about two weeks or less. Through early May 2005, over 51 million refunds were direct deposited, up from the 47.7 million refunds for the same period in 2004, an increase of almost 7 percent. The average direct deposit refund in 2005 is \$2,517, totaling \$128.4 billion, up 11 percent over the prior year. We expect this year's direct deposit numbers to be about 11 percent higher than last year's.
- **More accurate returns:** E-filed returns are automatically checked for errors or missing information. Processing is more accurate and the likelihood that a taxpayer might receive an error letter from the IRS is reduced.
- **Quick electronic confirmation:** E-filers receive an acknowledgement that we have received their returns.
- **Electronic signatures:** Taxpayers and their tax preparers can create a Personal Identification Number (PIN) and file a completely paperless return. Those who take advantage of this option do not mail anything to the IRS. This year taxpayers filed over 14.7 million returns that were signed using a PIN, up 24 percent from the previous year. Also, 35.5 million taxpayers e-filed through a paid preparer and used self-select PIN or a practitioner PIN, up 20 percent.
- **Free Internet Filing:** Now in its third year, Free File allows millions of taxpayers to prepare and file their Federal tax returns on-line for free. The program is a partnership between the IRS and an alliance of tax software companies that offers free on-line tax return preparation and e-filing services to at least 60 percent of the nation's 130 million taxpayers. As of May 1, 2005, Free File volume was over 5 million returns, 46 percent higher than last year's 3.4 million returns for the same period. Free File was principally designed to advance and increase e-filing receipts and assist taxpayers, particularly in underserved and disadvantaged communities. While each of the 20 companies participating in the program sets its own qualifying criteria for its free services, the majority of the offerings are designed to serve lower-income individuals or families who claim the earned income tax credit. Others are based on the taxpayer's age, military service, or state residency. Currently, 11 companies are offering free services for all taxpayers with no restrictions.
- **Easy payment options:** E-filers with a balance due can file early and schedule a safe and convenient electronic funds withdrawal from their bank account, or pay with a credit card. Almost 2.1 million people have paid their Federal taxes by electronic funds withdrawal or credit card in 2005, up from over 1.4 million in the prior year, a 47 percent increase.

- o Federal/State e-filing: Taxpayers in 37 states and the District of Columbia can e-file their Federal and state tax returns in one transmission to the IRS. The IRS forwards the state data to the appropriate state agency. In 2005, more than 32.3 million taxpayers filed Federal-state electronic returns.

Taking the Paper Out of Business Taxpayer Burden in 2004

The IRS has taken steps to decrease the burden of business taxpayers by introducing a variety of electronic services that will ease both information reporting and payment of taxes. Businesses file annual income tax returns but are also required to file various employment tax returns and information returns. They must also make periodic payments to the Federal Government, such as income tax withheld from employees' earnings and unemployment taxes. In fact, payments are a business's most frequent transaction with the IRS. We plan to convert all of these transactions to fast, accurate, paper-free electronic methods, and we are making progress on a number of fronts.

As of May 2005, over 5.1 million taxpayers are enrolled in the Electronic Federal Tax Payment System (EFTPS). These taxpayers have made over \$1.07 trillion in electronic tax payments through EFTPS, which now includes an on-line option.

In FY 2004, IRS received more than 2.4 million Form 941 (Employer's Quarterly Federal Tax Return) e-file program returns. In FY 2004, 351,396 businesses used the Form 940 (Employer's Annual Federal Unemployment Tax Return) e-file program, and more than 91,737 partnerships chose to e-file Form 1065 (U.S. Return of Partnership Income) in FY 2004.

IRS is also delivering several applications that provide tangible benefits to taxpayers and improve the efficiency and effectiveness of our tax administration system. They include:

Employment Tax E-File System

The Employment Tax E-File System offers an improved way for current Form 940 and 941 e-file and On-Line Filing Partners to file returns with the IRS, and for the first time, Electronic Return Originators (EROs) have the ability to offer electronic employment tax filing for their clients. The Employment Tax E-file System will provide more filing options, flexible filing, faster acknowledgements, an integrated payment option, a completely electronic signature process, and a Federal-state filing component, all of which will result in reduced burden for the tax preparation community and the taxpayers they represent.

E-Services

E-Services is a suite of Internet based products that allows tax professionals and payers to do business with the IRS electronically. These services include Preparer Taxpayer Identification Number (PTIN) applications with instant delivery, Taxpayer Identification Matching (TIN) matching for third-party payers, on-line registration for electronic E-Services, and on-line initiation of the electronic return originator application.

Incentives are being offered for E-Services registration, such as on-line disclosure authorization, electronic account resolution, and transcript delivery system. In addition, the availability of incentives to those tax professionals and payers that e-file has been lowered from 100 to 5 individual returns filed.

E-Services Registration is 50,000 for FY 2005, a 110 percent increase from the same time in 2004. Thirty-six percent of all PTIN applications are now received on-line. E-Services have almost doubled the number of TIN matching in 2005; Interactive Matching is over 1 million and Bulk Matching is over 28 million. E-File applications received on-line are 30 percent of the total volume in 2005. In 2005, E-Services processed 18,000 Disclosure Authorizations, 5,000 Electronic Account Resolutions cases, and 106,000 Transcript Delivery System requests.

Modernized E-File System (MeF)

On February 20, 2004, IRS launched the Modernized e-File (MeF) program. This new electronic filing program, developed and delivered through the IRS Business Systems Modernization program, gives corporations and tax-exempt organizations the ability to file annual tax returns electronically over the Internet. For the first time, electronic filing is available to corporations filing their corporate income tax returns, Forms 1120 and 1120S, and charitable organizations filing their annual Form 990, along with related forms and schedules. These forms are the first to be filed through a modernized e-file program that uses a secure Internet connection instead of a modem to transmit tax return data. Corporations filed more than 6 million Forms 1120 and charitable organizations filed 825,000 Forms 990 last year. The IRS has accepted over 134,000 returns in 2005, more than 100 percent of the total volume projected for this year.

More than 748,000 nonprofit organizations enjoy the benefits of burden reduction through the IRS' implementation of MeF for Forms 990. MeF effectively addresses the problem of rejected returns. Approximately 40 percent of exempt organizations' returns were rejected due to oversight, such as omission of required schedules, incorrect name or identification numbers, missing signatures, and mathematical errors. While IRS personnel were able to correct many of these errors, just as many result in the issuance of correspondence to the filer. This creates significant delays in the processing of these returns. E-filing will reduce many of the steps associated with IRS Service Center paper processing, including mail handling, editing, data entry, and error resolution. From the taxpayers' perspective, it will reduce taxpayer correspondence, mail handling, time spent trying to resolve errors, and recordkeeping.

The Form 990 series of returns is unique because each is a multi-jurisdictional form used by both the IRS and state regulators. The current plans for MeF are to enable single point filing to meet both Federal and state filing requirements. This capability will save state tax resources and eliminate duplicative filings by the taxpayer. Almost 1,000 Forms 990 have been filed through the MeF program in 2005.

Fed/State Electronic Federal Tax Payment System (EFTPS)

The IRS and the Treasury Department's Financial Management Service EFTPS have scheduled a two-state pilot for South Carolina and Illinois in January 2006. This pilot will enable taxpayers to pay their federal and states taxes at one website. In addition, federal and state tax withholdings will be made through a payment portal via one transaction and one Personal Identification Number (PIN). This initiative will make it more convenient and easier for taxpayers to make their federal and state tax payments.

Internet Refund Fact of Filing (IRFOF)

The inquiries to the on-line "Where's My Refund?" has increased to over 18 million this year. This is an increase of over 52 percent from 2004. The increased use of "Where's My Refund?" has reduced the number of phone calls from taxpayers seeking their refund status.

Future Electronic Initiatives

In the near future, the IRS will be offering additional incentives to taxpayers to file their returns electronically. These initiatives will reduce taxpayer burden. These incentives include:

- Web services & Fed/State MeF: In 2006, the IRS will partner with states to develop Corporation and Tax Exempt state filing and have begun initial work on state partnership returns.
- 1040 e-file: Taxpayers will be able to electronically file six new forms in 2006.
- MeF: Additional forms will become available for the Form 1120 in 2006 and the Form 1065 will be available in the MeF system in 2007.

In addition, the Administration's budget request contains a legislative proposal to extend the due date for electronically-filed returns and to require electronic filing by large businesses and exempt organizations. This will encourage more taxpayers to electronically file their returns.

Support of Government-Wide Paperwork Burden Reduction

The IRS has been supportive of all Government-wide efforts to reduce the regulatory and paperwork burden imposed on our customers, including aggressively addressing the requirements of the Small Business Paperwork Relief Act (SBPRA) of 2002. The IRS is well represented on the SBPRA task groups addressing Government-wide burden, making it easier for small businesses to understand their regulatory requirements, identifying ways to integrate and consolidate data, and making recommendations to improve the electronic collection and dissemination of data collected under Federal requirements. As the 2002 SBPRA Task Force recommended, the IRS is working with the Business Gateway E-Government Initiative to make it easier for businesses to interact with the Federal government and help to reduce burden through data harmonization and forms consolidation. In addition, periodic meetings are

held with SBA and OMB to discuss burden reduction efforts and to identify partnering opportunities.

Conclusion

Madam Chairman and members of this panel, reducing taxpayer burden is one of my strategic priorities and is the cornerstone of the Service aspect of our working equation at the IRS – “Service *plus* Enforcement *equals* Compliance.” Burden reduction is everyone's job at the IRS. Again, I appreciate the opportunity to testify before your committee and I welcome any questions.

Appendix

Past Burden Reduction Efforts

In response to the committee's request for a listing of our past burden reduction efforts, the following are our most significant initiatives from 1998 to 2004.

1998 and 1999

Simplification of Form 5500 Series: Form 5500, Annual Return/Report of Employee Benefit Plan, and related Forms 5500-C and 5500-R were replaced with one streamlined Form 5500 for use by all filers for the 1999 plan year. Forms 5500-C and 5500-R were eliminated and small benefit plans had less extensive reporting requirements.

1998 Form 1040 Tax Packages: Tax packages were improved to promote electronic filing and highlight tax law and form changes to make it easier for taxpayers to find the information they need. The graphics were also improved by adding more white space and larger print for improved readability. Extensive changes were made to the instructions of Form 1040-ES (Estimated Tax for Individuals) that resulted in a decreased burden of 3.7 million hours.

Moving Expense Reporting: The IRS combined Form 3903, Moving Expenses, and Form 3903-F, Foreign Moving Expenses, into one Form 3903. This change simplifies the decision for taxpayers as to which form to use and saves taxpayer dollars by only having one form for moving expenses.

Employment Tax Deposit Threshold: Effective July 1, 1998, the IRS increased the threshold for deposits of employment taxes from \$500 to \$1,000. This regulatory change significantly reduces the reporting burden for an estimated 1.5 million employers who will no longer be required to complete the Federal Tax Deposit coupons (or make deposits) or complete the record of tax liabilities on the employment tax forms.

Substantiation of Business Expenses for Travel, Entertainment, Gifts, etc.: Existing regulations had required supporting evidence, such as a receipt, for all expenses of \$25 or more for travel, entertainment, gifts, etc. The regulations were revised in 1997 to raise this receipt threshold to \$75, thus reducing the paperwork burden on taxpayers.

Relieving Burden of Reporting Capital Gain Distributions: Starting in tax year 1999, taxpayers whose only capital gains were from mutual fund distributions may not need to file Schedule D (Form 1040), "Capital Gains and Losses." Instead, these gains are reported directly on Form 1040, line 13. IRS developed a new worksheet in the 1040 instructions to assist taxpayers in calculating the tax.

Rather than having to complete the 54-line schedule, these taxpayers can use a much easier 15-line worksheet. The change to the worksheet represents a dramatic burden reduction of 23.76 million hours for approximately six million taxpayers.

Form 2210 Streamlining (Underpayment of Estimated Tax by Individuals, Estates and Trusts): We removed two lines from the 1999 Form 2210, Schedule AI, Part II. Schedule AI, Part II is completed by self-employed taxpayers to calculate their self-employment tax when computing any estimated tax penalty. Each line had four entry spaces, one for each payment period. These taxpayers now have two fewer lines to complete and eight fewer calculations to make.

2000 - 2001

Relieving Burden of Reporting Capital Gain Distributions: For tax year 2000, a line was added to Form 1040A for reporting capital gain distributions from mutual funds, thus allowing the IRS to send the simpler Form 1040A package to the approximately 2.5 million taxpayers who in the past had to file Form 1040 to report those distributions.

Checkbox Initiative: Beginning in tax year 2000, taxpayers with Paid Return Preparers can use the Paid Preparer Authorization Checkbox on all Form 1040 series returns with the exception of TeleFile. This checkbox indicates the taxpayer's desire to allow the IRS to discuss the tax return and attachments with the preparer while the return is being processed. This provides for a significant reduction in paperwork for millions of taxpayers.

Including a checkbox on the family of 1040 returns was a direct response to requests from our external stakeholders, such as the South Florida Citizen Advocacy Panel (CAP), National Society of Accountants, National Association of Tax Practitioners and National Association of Enrolled Agents.

The checkbox designation enables practitioners quickly to resolve questions concerning the processing of the taxpayer's return. It also reduces the number of contacts necessary to resolve processing questions and eliminate the need for the submission of paperwork for a Power of Attorney, which is not required to resolve simple problems with a taxpayer's account. This initiative also addresses the practitioner groups' concern that this designee not be afforded post-assessment correspondence or representation.

This initiative provided significant burden reduction for many taxpayers who would otherwise have to obtain and fill out Form 2848 (Power of Attorney and Declaration of Representative) and Form 8821 (Third Party Authorization Disclosure).

After we announced the initiative in April 2000, we expanded the check box authorization on the tax year 2001 Form 1040 series of returns to allow the designation of any third party, such as an elderly taxpayer's son or daughter, not just the paid

preparer, to discuss processing problems. This action allows more expeditious handling of processing and refund problems.

We also revised most business income tax returns with a paid preparer block to allow the designation of the paid preparer. For the major employment and excise tax returns, which do not have a paid preparer block, we added a section to allow taxpayers to designate either their paid preparer or an employee.

Reordering of Credits on Forms 1040 and 1040A: For tax year 2000, IRS reversed the order of the education credits line and the child tax credit line on these forms. This will allow filers claiming the child tax credit to figure that credit in a more logical manner (i.e., after they have figured any education credits). This reordering will also allow IRS to write simpler instructions because the Agency will not have to tell taxpayers to jump ahead to the education credits line, figure the credits, and then come back to the child tax credit computation.

Simplified Credit Calculation on Tax Year 2000 Form 8839, Adoption Credit: Instead of adding another line for credit carryforwards from 1999 to 2000, the IRS eliminated that proposed line (and existing lines for carryforwards from 1997 and 1998) and replaced it with one line for "carryforwards from a prior year." A worksheet in the instructions lets taxpayers calculate the amount to put on that line. The IRS eliminated lines on the form for prior year credit carryforwards to 2001 (four lines eliminated).

Excise Tax – Form 2290, Heavy Vehicle Use Tax Return Initiative: Each year, the IRS sends out approximately 790,000 Form 2290 tax packages to taxpayers potentially liable for the tax. Research performed by the IRS Cincinnati Service Center determined that approximately 265,000 taxpayers receiving the package had not filed a Form 2290 for the past three years.

By analyzing our internal databases, the IRS was able to notify over 239,000 taxpayers that they may no longer be liable for the tax. It takes approximately 30 minutes to read the Form 2290 filing instructions and determine if a liability exists. Multiplying this time by the 239,000 taxpayers, we reduced taxpayer burden by 119,793 man hours. There are 500,000 Forms 2290 filed annually with tax liabilities of \$800 million dollars.

Employment Tax Deposit Threshold: In 2001, in an effort to provide even more burden relief to small business employers, the IRS raised the employment tax deposit threshold again, from \$1,000 to \$2,500 in quarterly employment taxes. This affects the payment requirements for about one million small businesses. Through our continued efforts, we estimate that between 70-80 percent of small businesses can be relieved of the burden of making as many as 12 deposits annually.

Change of Address: Beginning in 2000, a licensing agreement between the IRS and the U.S. Postal Service, allowed taxpayers who move after filing their tax returns to have their addresses automatically updated, even if they do not notify us by filing Form 8822, Change of Address.

Under this arrangement, the IRS will use the Postal Service's National Change of Address (NCOA) database to update the addresses in its own Master File of taxpayer data. This address updating process provides quicker resolution of undelivered refund checks. The IRS checks the names and old addresses in the NCOA weekly update files against the names and addresses in the IRS database. Where there is an exact match, the IRS updates its file with the taxpayer's new address. According to the Postal Service, there are about 800,000 address changes each week.

In addition to helping IRS get refunds to taxpayers, this program permits the IRS to make earlier contacts with them to resolve issues such as delivery of a returned refund, possible unreported income, examination of a return, or collection of unpaid tax.

Cash Versus Accrual Methods of Accounting: In April 2000, the IRS issued Revenue Procedure 2000-22 (later modified and clarified by Revenue Procedure 2001-10) which permits qualifying business taxpayers with average annual gross receipts of \$1,000,000 or less to use the cash receipts and disbursements methods of accounting. This action also provides the procedures by which a taxpayer may obtain automatic consent to change to the cash method.

This procedure had an enormous impact on lessening burden for small businesses that could use the much simpler, easier to understand, and usually advantageous cash method. By our calculations, we have exempted the vast majority of the small business taxpayers who otherwise would have been required to use an accrual method.

2002-2003

Burden Relief for Smaller Corporations: Exempting Some From Filing Schedules L, M-1, & M-2: For tax years beginning in 2002, we exempted corporations having less than \$250,000 of gross receipts and \$250,000 in assets (both tests must be met) from completing Schedules L, M-1, & M-2 of Form 1120; Parts III and IV of Form 1120-A; and Schedules L and M-1 of Form 1120S. These changes established a more reasonable threshold for these businesses. It allows them to use recordkeeping based on their checkbook or cash receipts and disbursements journal, for example, instead of a double-entry system until they grow to the point where more internal controls would be needed.

Schedule L (Part III of Form 1120-A) provides beginning and end of the year balance sheets based on the corporation's books. Typically, corporations with less than \$250,000 of gross receipts and assets prepare a formal balance sheet only because it is required for income tax purposes. Formally relieving them of this preparation step does not cause undue hardship in an audit situation. However, taxpayers will still be required to maintain records detailing their assets, liabilities, and shareholders' equity accounts.

Schedule M-1 (Part IV of Form 1120-A) provides a reconciliation of income (loss) per accounting records with the income (loss) reflected on the tax return. Since generally

accepted accounting principles (GAAP) do not always mirror the tax reporting requirements, Schedule M-1 provides a bridge between book accounting and tax reporting.

Typically, the Schedule M-1 is completed as the first step in preparing the tax return. The preparer will start with the book income (loss) as reflected on the final trial balance. The next step would be an analysis or comparison between the tax treatment of specific items and how they are reflected on the books.

For example, while a capital loss is fully deductible per GAAP, for tax it can only be used to offset capital gains. Therefore, if a net capital loss was deducted for book purposes, it would have to be added back in arriving at taxable income.

While an analysis of Schedule M-1 is recognized as an integral step in the audit process, in the examination of corporate tax returns with less than \$250,000 of gross receipts and assets, it generally has limited application. Specifically, most of the corporations falling into this classification reflect limited activity on the M-1. Generally, if there is a net income, the M-1 will show entries on line 1 (Net income [loss] per books), line 2 (Federal income tax per books), and line 10 (Income, line 28, page 1).

At the time of this change, the reality was that the greater number of corporations having less than \$250,000 in gross receipts and assets do not properly adjust between book accounting and tax reporting. Formally relieving them of this preparation step does not cause undue hardship in an audit situation. However, taxpayers will still be required to maintain records detailing all adjustments made to book income in arriving at taxable income.

We also examined Schedule M-2, which analyzes unappropriated retained earnings. As with the M-1, for corporations with less than \$250,000 in gross receipts and assets, the M-2 reflects little more than the beginning balance affected by the current income (loss) and the ending balance.

Again, for the size corporations being discussed, formally relieving the obligation to complete the schedule M-2 will not have a detrimental impact from an examination standpoint. However, as with the M-1, if there are changes to retained earnings other than just the current income (loss), the taxpayer must be required to maintain proper records detailing said changes.

Filing Requirements for Schedule B Changed: In September 2002, the IRS and Treasury Department announced an increase in the threshold for filing a separate schedule for interest or dividend income. The change meant that more than 15 million taxpayers will have one less schedule to file with their tax returns.

For their 2002 tax returns, most taxpayers did not have to file a separate schedule if they have interest or dividend income of \$1,500 or less. Form 1040 filers use Schedule

B, Interest and Ordinary Dividends, to list the names of those who paid them along with the amount; Form 1040A filers use Schedule 1.

The new IRS standard replaced the existing reporting threshold of \$400 that has been in place since 1974. Without the shift, more than 40 million taxpayers would have had to file Schedule B or Schedule 1 in 2003.

This change also enabled another 800,000 taxpayers to use the shorter Form 1040EZ or use TeleFile to file their tax returns by telephone by increasing the maximum amount of interest income they can report to \$1,500.

As in past years, certain taxpayers with bank or other financial accounts in a foreign country (and certain taxpayers involved in foreign trust transactions) must continue to file Schedule B, regardless of the amount of interest or dividends they receive.

Taxpayers with ordinary dividends and taxable interest, each of which, do not exceed the \$1,500 threshold will report only the totals on their Form 1040.

Day Care Providers: In late 2002, the IRS announced that family day care providers may now choose to use a standardized rate to claim the deduction for meals provided to children in their care. This is in lieu of keeping detailed records and receipts for food purchased for use in their business. Use of the standardized rate significantly reduced the recordkeeping burden of family day care providers, which are predominantly small businesses.

The change means day care providers will save a conservatively estimated 10 million hours by using the standard meal rate. If these providers decide not to use the rates, they can continue to take the deduction based on the actual cost of the meals.

Checkbox on Social Security Benefits Worksheet: For tax year 2002, we deleted two checkboxes on the Social Security benefits worksheet used by individual taxpayers, reducing burden by as much as a million hours for filers of Form 1040.

Prior to 2002, if a taxpayer checked "No" on line 2, it meant the Social Security benefits reported in box 5 of Form SSA-1099 were less than zero and there would be no taxable benefits. If a taxpayer checked "Yes," the taxpayer would enter one-half of line 1. Since an amount reported in box 5 of Form SSA-1099 is rarely less than zero, the checkboxes have been deleted, thereby eliminating unnecessary burden. Line 2 has been replaced with "Enter one-half of line 1."

Reducing Burden on Form 6251: For tax year 2002, we reduced complexity and taxpayer burden by eliminating 11 lines on Form 6251 (Alternative Minimum Tax – Individuals). This reduction was accomplished by eliminating unnecessary subtotal lines and consolidating other lines. We estimate that 4.2 million taxpayers will benefit from these changes and reduce burden by over 1 million hours.

Coverdell ESAs: In the past, everyone receiving a distribution from a Coverdell education savings account (ESA) had to file Form 8606 (Nondeductible IRAs) even if all of the distribution was used for education expenses. The IRS eliminated this requirement beginning in tax year 2002. This eliminated 5 entry spaces and aligned the reporting of these distributions to Section 529 plans (qualified tuition plans).

Relieving Burden of Reporting Capital Gains Distributions: For tax year 2001, we reduced paperwork burden for millions of taxpayers who were filing the 54-line Schedule D. Rather than adding four more lines to an already crowded form to accommodate the new 8 percent capital gains rate, we looked for creative ways to shorten the form. When filing their taxes in 2002, more than 21 million Schedule D filers discovered that they had a form that is 40 lines long.

2004

Standard Mileage Rate: To reduce recordkeeping burden, IRS expanded the use of the standard mileage rate for taxpayers with multiple vehicles. Starting in 2004, the standard mileage rate may be used for up to four vehicles in the taxpayer's business. Previously, those businesses owning more than one vehicle for use in their business could not use the standard rate at all, leaving them to track the actual expenses for each vehicle. With this change, more than 800,000 businesses will be eligible to use the standard mileage rate, saving 8-10 million hours in recordkeeping burden. Revenue Procedure 2003-76 contains additional information on the standard mileage rates.

Reduced and Increased Burden on Individual Income Tax Returns: We made changes to the 2003 Forms 1040 and 1040A and their instructions and schedules that reduced estimated burden by almost 12 million hours. This included changing the Schedule SE, Self-Employment Tax, to allow taxpayers to skip lines on the form if they are only liable for the Medicare portion of the self-employment tax. However, the burden on Forms 1040 and 1040A was estimated to increase by over 28 million hours to implement tax legislation, the Jobs and Growth Tax Relief Reconciliation Act of 2003. This Act provided significant benefits to individuals and businesses, despite the net increase of 16 million burden hours.

Consolidation of Publications Relating to Tax Benefits for Education:

We have made obsolete Publication 508, *Tax Benefits for Work-Related Expenses*, and Publication 520, *Scholarships and Fellowships*. The information in these publications has been added to Publication 970, *Tax Benefits for Education*. Taxpayers and tax practitioners now have one primary source for information in this area of tax benefits.

Form 8855: We developed a new Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*, for executors and trustees. With this form, taxpayers have a format to follow and can be sure to include all the necessary election information prescribed by the regulations. An official IRS form is easier for taxpayers to use than a self-prepared statement and enhances compliance. It also allows the IRS to more

accurately process elections, thus minimizing the need for IRS employees to contact taxpayers in order to resolve questions arising from such elections.

Schedule D: We simplified the 2004 Schedule D, Form 1040 by eliminating Part IV, *Tax Computation Using Maximum Capital Gains Rates*. Instead, taxpayers will use the *Qualified Dividends and Capital Gain Tax Worksheet*. Previously, only taxpayers who were not required to file Schedule D used this worksheet. In focus group tests, taxpayers preferred the format of the worksheet to Part IV. Although this change does not result in quantifiable burden reduction under our current method of measuring burden, we are responding to customer preferences. The implementation of the 2003 tax law changes (eliminating the special treatment of 5-year gains and the pre-May 6, 2003, capital gain tax rates) will also result in burden reduction. In 2003, the reporting burden on Schedule D was 123.8 million hours. For 2004, the reporting burden is estimated at 109 million hours, or 14.8 million fewer hours.

Business Credit Forms: For Tax Year 2004, we deleted 7 lines from each of 19 general business credit forms (for a total reduction of 133 lines) by replacing 8 separate lines for tax credits with a single line. These changes will reduce taxpayer-reporting burden by almost 3 million hours in tax year 2004. The affected forms are:

- Form 3468, Investment Credit;
- Form 3800, General Business Credit;
- Form 5884, Work Opportunity Credit;
- Form 6478, Credit for Alcohol Used as Fuel;
- Form 6765, Credit for Increasing Research Activities;
- Form 8586, Low Income Housing Credit;
- Form 8820, Orphan Drug Credit;
- Form 8826, Disabled Access Credit;
- Form 8830, Enhanced Oil Recovery Credit;
- Form 8835, Renewable Electricity Production Credit;
- Form 8844, Empowerment Zone and Renewal Community Employment Credit;
- Form 8845, Indian Employment Credit;
- Form 8846, Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips;
- Form 8847, Credit for Contributions to Selected Community Development Corporations;
- Form 8861, Welfare-to-Work Credit;
- Form 8874, New Markets Credit;
- Form 8881, Credit for Small Employer Pension Plan Startup Costs;
- Form 8882, Credit for Employer-Provided Childcare Facilities and Services; and
- Form 8884, New York Liberty Zone Business Employee Credit.

Ms. MILLER. Thank you very much.

Our next witness is Dr. John Graham. He is the Administrator of OMB's Office of Information and Regulatory Affairs. Born and raised in Pittsburgh, Dr. Graham found and led the Harvard Center for Risk Analysis from 1990 to 2001. He was confirmed in July 2001. He is on leave from the faculty at Harvard School of Public Health, where he taught graduate students the method of risk analysis and cost-benefit analysis.

Dr. Graham, we certainly appreciate your coming today as well, and look forward to your testimony, sir.

STATEMENT OF JOHN D. GRAHAM

Mr. GRAHAM. Good afternoon, Chairwoman Miller and Congressman Lynch. I am pleased to be here this afternoon to summarize for you our recent report to Congress on the paperwork burden of the Federal Government on the American people. This report we have shared with you has some good news and it has some bad news. And I will summarize a little bit of both of that.

On the good news side, in fiscal year 2004, we saw Federal agencies take steps to slash paperwork burden by 96.8 million hours. While that roughly 100 million hour reduction is small compared to the billions of hours of total burden, for those people who have less burden that they have experienced as a result of these actions, we owe them, the agencies, applause and an encouragement to do more.

The bad news I must share with you is that new statutory requirements passed by Congress, and I'm sure some of them were supported by the administration, caused an increase in the burden of 119 million burden hours. The result of these two program changes, reductions in discretionary paperwork, increase in congressionally mandated paperwork, is that the net change in paperwork burden has been up in fiscal year 2004.

However, lurking behind these numbers, and we focus on the agency of concern here, the Internal Revenue Service, is some more good news. That is, much of the Government-wide reduction in paperwork burden due to agency actions is attributable to the agency that Commissioner Everson runs. Program changes at IRS reduced burden by 137 million hours, a significant fraction of that from a simplified individual income tax return. In this particular area of IRS paperwork, there were adverse trends from statutory changes from Congress which increased burden by 101 million hours.

But notice, for IRS the success of Commissioner Everson's people in reducing paperwork burden has overwhelmed the increases passed in the Tax Code. This net accomplishment is 36 million fewer hours of paperwork burden for the American taxpayer.

Now, I don't mean to criticize necessarily these statutory changes passed by Congress and supported by the administration. But I want to explain to you how well-intentioned legislation may increase paperwork burden. An example is the recent tax benefit provided to school teachers. The Tax Code now allows teachers to subtract up to \$250 from their taxable income for the purchase of classroom supplies. To implement this tax benefit, IRS had to provide a new explanation on the 1040 about their eligibility. That is additional paperwork.

They also had to provide a separate worksheet which is needed to be provided so school teachers seeking to claim this benefit can document their eligibility and their need. This separate worksheet increases paperwork burden.

So the illustration I'm giving you is just one concrete example why, if we go provision by provision in the Tax Code and try to reduce burden, we're going to have a long haul ahead of us. That is of course why the President is deeply interested in a substantially simplified Tax Code.

Our role at OMB in this area is an oversight one. Our desk officers at OIRA review over 3,200 information collections from Federal agencies each year. As you can imagine, with a couple dozen staff, we focus our energies on some key areas. We look at new information collections or revised information collections with particular priority.

During my tenure, we have devoted a specific attention and priority to slashing agency violations of the Paperwork Reduction Act. A typical agency violation is when they impose on citizens or taxpayers a requirement to fill out paperwork when they don't have approval from OMB to engage in that activity. We have adopted, in this administration, a zero tolerance policy toward these paperwork violations. I am proud to say that since 1998, the number of these violations has gone from 325 to zero in 2004, our most recent report to this subcommittee.

Of course, we have a lot of work ahead of us. We now need to work with agencies to prevent these violations from occurring in the first place rather than fixing them after the fact, and much work remains to be done in this subject.

So in conclusion, we're making progress. But at the same time, we are creating more paperwork burden with the laws we pass, sometimes well-intentioned and constructive laws. It is a complex problem and does not lend itself to easy solution.

Thank you very much.

[The prepared statement of Mr. Graham follows:]

**STATEMENT OF JOHN D. GRAHAM, PH.D.
ADMINISTRATOR
OFFICE OF INFORMATION AND REGULATORY AFFAIRS
OFFICE OF MANAGEMENT AND BUDGET
EXECUTIVE OFFICE OF THE PRESIDENT OF THE UNITED STATES**

**BEFORE THE
SUBCOMMITTEE ON ENERGY POLICY, NATURAL RESOURCES
AND REGULATORY AFFAIRS
COMMITTEE ON GOVERNMENT REFORM
UNITED STATES HOUSE OF REPRESENTATIVES**

May 25, 2005

Good afternoon, Madam Chair, and Members of this Subcommittee. I am John D. Graham Ph.D., Administrator, Office of Information and Regulatory Affairs (OIRA), Office of Management and Budget. Thank you for inviting me to testify about OIRA's responsibilities under the Paperwork Reduction Act (PRA) and our efforts to reduce paperwork burden on the public.

I would like to take this opportunity to welcome you to the world of government paperwork. I am confident that, as the new chair of this Subcommittee, your leadership on this issue will benefit greatly from your experiences as a businesswoman and as a government official at the State and local levels. I look forward to working with you and the Subcommittee building on our previous efforts to reduce paperwork burden across the Federal government and ensuring compliance with the requirements of the PRA.

In your letter of invitation, you specifically requested that my testimony address burden reduction efforts undertaken by the Internal Revenue Service (IRS) since 1996 in accordance with the PRA. Before discussing these IRS measures, I would like to review briefly the burden reduction provisions of the PRA.

The 1995 PRA directed OMB to set, in consultation with agencies, annual government goals for the reduction of information collection burdens – 10 percent each for FY 1996 and FY 1997, and 5 percent each for FY 1998-2001. To understand these government-wide burden reduction goals, it is important to put them into context. Specifically, the 1995 PRA states that OMB establish burden reduction goals that (1) “represent the maximum practicable opportunity in each agency”; (2) “are consistent with improving agency management of the process for the review of collections of information, and (3) “improve information resources management in ways that increase the productivity, efficiency and effectiveness of Federal programs.”

In other words, the PRA set aspirational paperwork reduction goals that called on OMB and agencies to consider the practicality and impact on programs of efforts to alleviate reporting burdens. As the experience with IRS demonstrates, the need to account for factors such as statutory requirements hindered the Federal government's ability to achieve the PRA's burden reduction goals.

Internal Revenue Service Efforts to Reduce Burden (1996 – 2004)

Approximately 80 percent of the Federal paperwork burden is associated with the tax system administered by the IRS within the Department of the Treasury. More than any other Federal agency, IRS relies on individuals and businesses to devote significant amounts of time and resources to ensure compliance with Federal requirements. Specifically, IRS collects information from the public and requires the maintenance of records to (1) determine if the correct amount of taxes, fees, and other revenue has been paid and (2) identify errors and correct them.

Since 1996, IRS has undertaken a range of initiatives targeted at reducing paperwork burden on the public including simplifying and redesigning forms; increasing the use of technology and electronic commerce; and reengineering processes. For example, in 1996 IRS simplified the 1040 individual taxpayer form decreasing respondent burden by almost 60 million hours, in 2002 IRS introduced the Free File system allowing taxpayers to file electronically for free over the internet, and in 2002 IRS created the Office of Taxpayer Burden Reduction to develop burden reduction initiatives that would significantly relieve respondent burden. Despite these efforts, statutory requirements and increased usage of tax forms have more than offset IRS initiatives to reduce paperwork burden. Nonetheless, these initiatives have helped to ensure that paperwork burden is minimized to the extent possible.

OMB has regularly reported on IRS burden reduction measures in the Information Collection Budget (ICB), our annual account to Congress required by the PRA. For an annual summary of IRS efforts from 1996 – 2004, please see Appendix A to my Testimony.

Department of the Treasury Burden as Reported in the FY 2005 Information Collection Budget

In FY 2004 the Department of the Treasury reported a decrease in burden of 184 million hours relative to FY 2003. The majority of this decrease – 147 million hours – resulted from a number of significant adjustments—refinements in the measurement of the number of respondents or burden hours—many of which were due to new estimates of the number of filers of IRS forms.

In addition to an overall decrease of burden hours associated with adjustments, Treasury reported a net reduction in burden associated with program changes, which result from agency actions or implementation of new statutory requirements. While these figures were reported on a department-wide basis they closely parallel changes in IRS burden, which represents the most significant component of Treasury burden. Net program changes for Treasury in FY 2004 resulted in a reduction of 36.3 million hours, despite the fact that new statutory requirements increased Treasury burden by 101 million hours.

Among statutorily driven burden increases, changes in recent legislation enacted to provide tax relief resulted in significant additional burden. For example, changes in the Income Tax Return for Estates and Trusts required by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (P.L. 108-27) resulted in a burden increase of 12.3 million hours. Nevertheless, these program change increases were more than offset by discretionary program changes that reduced burden 137 million hours. IRS, for

instance, eliminated sections of the individual income tax return in response to public input, which resulted in a net decrease of 34.4 million hours.

Additionally, IRS is evaluating its current burden assessment methodology. The current methodology is based on survey data almost 20 years old and measures only certain types of taxpayer compliance burdens. The new model represents a shift in the approach for measuring burden: it focuses on the taxpayer and the taxpayer's characteristics rather than the forms the taxpayer uses. Key drivers of taxpayer burden in the new model are who prepares the return and the taxpayer's activities. In contrast, the current model primarily focuses on the burden incurred for each form. A major goal of the project has been to provide IRS with the capability to do "what if" analysis to guide burden reduction efforts and to inform agency decisions on tax administration matters. The model represents a major step forward in IRS' ability to assess likely impacts on individual taxpayers before making changes. Please see Appendix B of my Testimony for additional details addressing the new IRS burden accounting methodology.

Paperwork Burden Across the Federal Government

In FY 2004 total paperwork burden was 7.971 billion hours, a decrease of 128 million hours or 1.6% from an FY 2003 total burden of 8.099 billion hours. In FY 2004, total adjustments accounted for a net decrease in Federal paperwork burden. It is principally due to these changes that aggregate burden decreased.

OMB classifies burden hours associated with paperwork transactions into two categories: (i) adjustments (re-estimates of burden resulting from changes in the population affected by a collection or more accurate estimations of the time required to comply with a collection) and (ii) program changes (which result from agency actions or implementation of new statutory requirements). The overall decrease in burden reflected a combination of both net program changes and net adjustments.

During FY 2004, total program changes resulted in a net increase in burden hours, which slightly offset the net decrease in adjustments. This overall program change increase combined changes due to discretionary agency actions and new statutory requirements. Within the first category of program change, discretionary actions, agencies were able to reduce burden by a net of 96.8 million hours. Despite this net reduction, total program changes resulting from new statutory requirements increased paperwork requirements and imposed 119 million hours of burden.

Paperwork Reduction Act Compliance

The PRA requires Federal agencies and OMB to ensure that information collected from the public minimizes burden and maximizes practical utility. The Act assigns each agency's Chief Information Officer (CIO) the responsibility for ensuring that the agency complies with the PRA. OMB's Office of Information and Regulatory Affairs (OIRA) is responsible for approving information collection reviews under the PRA. OIRA desk officers review and approve over 3,200 information collections each year.

During my tenure as OIRA Administrator, OMB has adopted a "zero-tolerance policy" for violation of the PRA. These violations occur when an agency collects information

from the public without OMB approval. During the past year, we have worked diligently with agency staff and policy officials toward eliminating expired collections and resolving, if any, violations prior to publication of the ICB report.

I am pleased to report that agencies have reduced outstanding violations, at the time of OMB's submission to Congress of the *FY 2005 Information Collection Budget*, from 325 in FY 1998 to 0 in FY 2004.

Furthermore, to help the public and the agencies monitor compliance with the information collection provisions of the PRA, OMB annually publishes a list of violations. During FY 2004, the agencies reported 89 information collections that expired during FY 2004 (10/1/2003 to 9/30/2004). In addition, the agencies reported 75 pre-existing collections that had expired before October 1, 2003 and were on-going violations until their reinstatement dates in FY 2004.

Agencies have made great progress in reducing the number of violations that occur and in resolving them more promptly. However, it is still the case that a considerable number of collections become violations each year because agencies do not submit to OMB, on a timely basis, requests for renewal of OMB approval under the PRA.

Steps to Improve Agency Compliance

We believe that the elimination of unresolved violations stems directly from our heightened efforts throughout the last three and a half years. In addition to the routine efforts to inform agency staff, OMB has taken some additional measures to eliminate violations, including:

On September 27, 2004, OMB sent a Memorandum to the President's Management Council and to agency Chief Information Officers and General Counsels detailing the importance of eliminating agency PRA violations. OMB requested that the Chief Information Officers of each agency provide a description of the structure agency had, or will put in place, to ensure the prevention of PRA violations in the future.

This month I have begun meeting individually with the Chief Information Officers and General Counsels of the 8 agencies with the largest number of violations reported in FY 2004 to discuss methods for reducing the number of violations. I am requesting that the agency CIOs ensure all their violations in FY 2005 be reinstated, with OMB approval, by the end of this fiscal year.

Agency Initiatives to Reduce Burden

An underlying goal of the Paperwork Reduction Act is to minimize the Federal paperwork burden on the public. As part of the submission for this year's ICB report, OMB requested agencies with total burden equal to or in excess of 10 million hours to provide OMB with up to three initiatives that will result in a cumulative burden reduction level of approximately 1% of their FY2004 total agency burden. These burden reduction initiatives vary across government agencies; however, all initiatives are designed to improve program performance, reduce the burden per response on the public or lead to a

comprehensive review of an entire regulation, guidance document or program, Appendix C of my Testimony lists a number of significant burden reduction initiatives.

That concludes my prepared testimony. I would be happy to answer any questions you may have.

Appendix A: IRS Burden Reduction Initiatives (1996 – 2003)*FY 1996*

Simplifying and Redesigning Forms: The IRS made several changes to the 1040 form and instructions that reduced the paperwork burden of individual taxpayers by almost 60 million hours. These changes included producing a separate, streamlined set of instructions for use by 10 million taxpayers that file the simplest 1040 returns and eliminating a net of 20 lines from the 1040 form and instructions.

FY 1997

Increased Use of Technology: IRS expanded the availability of paperless, electronic tax filing options to reduce taxpayer recordkeeping and reporting burdens. Among the benefits of electronic filing are significant reductions in errors, which in turn reduce the number of notices sent to taxpayers, and faster processing of returns by IRS

FY 1998

Simplifying and Redesigning Forms: The 1998 individual income tax packages, which include the primary forms and instructions, were improved to highlight tax law and form changes to make it easier for taxpayers to find the information they need. The covers of the packages highlighted the new child tax credits and education benefits, reminded taxpayers that Social Security numbers must be entered on the return since they were no longer on the labels, and promoted electronic filing. Inside the Form 1040 package, there was more white space and larger print for improved readability. In case IRS needed to contact the taxpayer while the return was being processed, there was an optional space on Forms 1040 and 1040A for the taxpayer to enter a daytime telephone number. Information about taxpayer assistance services like Forms by Fax were moved to the front of the booklet.

Increased Use of Technology: IRS made tax forms available on its website, making them easier for taxpayers to obtain. The IRS also improved its early release forms program by making the draft forms available on the IRS Internet website. The drafts are accessible for review and comment by the public to be more responsive to customers' needs and concerns.

FY 1999

Increased Use of Technology: IRS made significant investments in information technology as part of its overall modernization efforts. In late FY 1999, the IRS awarded a major contract for a multi-year systems improvement effort. The IRS also made Electronic Tax Administration (ETA) a top priority. ETA reduces taxpayer burden by making it easier and faster to file returns and communicate with the IRS. One key initiative for FY 2000 was expanding the use of identification numbers to facilitate secure filing by tax preparers. The IRS also made electronic payment options available, and accepted more forms and schedules through e-filing. The IRS also provided businesses a growing number of electronic filing and payment options.

FY 2000

Reengineering processes: IRS worked to improve its administration of the tax laws to reduce the time the public spends working on taxes. For example, IRS transferred 2 million taxpayers from the 1040 to the simpler 1040A, which reduced overall burden by 2.4 million hours. The agency also continued to work on electronic filing to make the public's task easier and less likely to result in errors.

Reengineering processes: IRS sought to reduce taxpayer burden in a variety of ways including regulations and guidance. For example, several items of recently published guidance reduced paperwork requirements, made it easier for taxpayers to file returns and other information with the IRS, or made it easier for taxpayers to comply with tax laws and regulations e.g.: *Participation in Annuity and Deferred Compensation Plans, Revenue Rulings 2000-33 and 35, and Announcement 2000-60*: IRS also allowed for automatic enrollment of participants in 403(b) annuity plans, 457 governmental and tax exempt deferred compensation plans, and 401(k) prototype plans. This made the participation process easier to initiate for both workers and employers.

FY 2001

Increased Use of Technology: Each year, the Internal Revenue Service (IRS) receives well over 200 million tax returns. The majority of these transactions are submitted by standard mail, not electronic filing. While electronic filing is easier and can reduce the amount of time taxpayers spend filling out their returns, it requires citizens to purchase commercial software products. Thus, the burden on taxpayers who choose electronic filing is not been eliminated; it has simply been shifted from time to cost. Free File was introduced to reduce the burden on taxpayers who choose electronic filing by removing the costs to the public of filing and preparing taxes electronically. Under this initiative, taxpayers were able to use the Internet to input data on-line and file their taxes quickly and easily. Free File, an industry partnership, gave most individuals the option to file and prepare his or her tax return online for free.

FY 2002

Reengineering processes: The IRS devotes considerable resources to development of forms in a manner that minimizes burden. Forms development within IRS is a rigorous procedure that utilizes the policy and graphic layout expertise of numerous individuals as well as, when appropriate, public focus groups.

Office of Taxpayer Burden Reduction: In recognition of the importance of reducing paperwork, in January 2002, IRS created the Office of Taxpayer Burden Reduction (OTBR). This office seeks to achieve significant burden reduction for taxpayers by developing proposals that foster burden reduction; by coordinating and championing burden reduction efforts throughout the IRS; and by working with others in IRS, Congress, States, other Federal agencies, and the small business community to develop, coordinate and implement meaningful burden reduction efforts that are consistent with IRS's customer service and compliance goals.

Simplifying and Redesigning Forms: IRS redesigned Form 941. This project to review and redesign this form affected 6.6 million employers. IRS's form redesign group determined that some existing space on the form was used for internal processing and could be made available for improved formatting and readability.

FY 2003

Simplifying and Redesigning Forms: In the 2002 tax year IRS implemented an increased threshold affecting small businesses who file corporate income tax returns. Companies with less than \$250,000 of gross receipts and less than \$250,000 in assets no longer needed to report certain information. For larger companies these schedules are necessary tools in the examination of corporate returns but for most small businesses they have limited application. The changes were estimated to affect 2.6 million small businesses and were computed to reduce burden by 33.7 million hours for Form 1120 and 3.4 million hours for Form 1120-A.

Appendix B: New IRS Burden Accounting Methodology

IRS is currently evaluating its current burden assessment methodology, which although vastly more sophisticated than that used by most Federal agencies, has recognized shortcomings. The current methodology is based on survey data almost 20 years old and measures only certain types of taxpayer compliance burdens. It has limited ability to predict changes in compliance burden resulting from changes in tax policy or tax system administration.

The new Individual Taxpayer Burden Model (ITBM) will revise the benchmark indicators of the levels of burden experienced by individual taxpayers when complying with the Federal Income Tax Code. Improved technology, increased computer capabilities and modeling sophistication afford IRS the capability to improve the method for estimating burden and develop a complex micro simulation model. IRS and its consultant, IBM Business Consulting Services, developed the ITBM over a period of six years. An interagency advisory group has contributed expertise throughout the project development. The transition to the ITBM estimates will occur in 2005, and the 2005 tax forms (for use by 2006 filers), will include the new estimates.

The ITBM will provide the IRS a more comprehensive methodology for assessing taxpayer burden, both current levels and the potential impact of legislative and administrative changes, than previous approaches. A major goal of the project has been to provide IRS with the capability to do “what if” analysis to guide burden reduction efforts and to inform agency decisions on tax administration matters. The model represents a major step forward in IRS’ ability to assess likely impacts on individual taxpayers before making changes. For example, if dollar thresholds for a provision are adjusted, IRS officials need to understand the impact on taxpayer burden beforehand. IRS’ administrative efforts to reduce burden by redesigning tax forms, changing record keeping requirements, or addressing changes in taxpayers’ behavior, such as increased use of software or paid professionals can be evaluated using the new model.

The new model represents a shift in the approach for measuring burden: it focuses on the taxpayer and the taxpayer’s characteristics rather than the forms the taxpayer uses. Key drivers of taxpayer burden in the new model are who prepares the return and the taxpayer’s activities. In contrast, the current model primarily focuses on the burden incurred for each form. The changes between the current and new burden estimates are due to improved methodology and the expanded scope of what is measured. This will create a one-time shift in burden levels.

Appendix C: Agency Burden Initiatives

Summaries of agencies that reported a 1% burden reduction are as follows:

- *Employers Annual Federal Tax Program (Form 944)* - The IRS is undertaking a Taxpayer Burden Reduction project to reduce burden on the smallest of small business taxpayers by establishing new rules and processes that will allow certain employers to file their Employment Tax (ET) returns, as well as pay the ET tax due, on an annual basis. Currently all employers are required to file a Form 941, Employer's Quarterly Federal Tax Return, on a quarterly basis. This form is used to report wages paid federal income tax and Social Security/Medicare taxes withheld from the employees' compensation and the employer's matching Social Security tax amount. The Form 941, in general, must be filed quarterly, regardless of the amount the employer owes. Submission of the amounts withheld must be paid with the return if less than \$2500 per quarter. If the total is \$2500 or greater, then the taxpayer must make more frequent Federal Tax Deposits based upon a specific schedule. There are approximately 6 million entities that file Form 941 each year, for a total of 24 million returns.

To accomplish the initiative of reducing burden on the very smallest of business taxpayers, the IRS is developing a new Form 944, Employer's Annual Federal Tax Return. This program will be for those employers who owe less than \$1000 a year in total Employment Taxes (i.e., withheld income, Social Security and Medicare taxes, as well as the employer's matching amount for Social Security). They will also be allowed to pay what they owe with the annual return due each January 31st for the prior calendar year. This means a significant reduction in burden for these taxpayers: they will have only one form to file rather than four forms, and only one annual payment due with the annual return. IRS estimates this initiative will result in a burden reduction of 51,000,000 hours

- *Controlled Substances Ordering System (CSOS)* - The Justice Department currently requires controlled substances manufacturers, distributors, practitioners, and pharmacies use form DEA-222 to transfer or purchase Schedule I and II controlled substances. Use of this form is mandated by the Control Substance Act to document the movement of these controlled substances. DEA is implementing a system using Public Key Infrastructure technology to permit the electronic transmission of these controlled substances orders resulting in a burden reduction of 1,127,464 hours.
- *Performance Based Data Management Initiative (PBDMI)* - During FY 2005 PBDMI will be the focus of the Department of Education's efforts to reduce respondent burden. PBDMI will fundamentally transform the way that the Department accesses information and meets the requirements of the *No Child Left Behind Act*. The initiative will produce an Education Data Exchange Network (EDEN), providing State Education Agencies and the Federal government the capacity to transfer and analyze information about education programs. When

fully implemented, EDEN will not only provide timely performance data to education decision makers and grant managers but also streamline the data collection process and reduce the burden of grant reporting resulting in an estimated aggregated burden decrease of 410,000 hours.

Ms. MILLER. Thank you both, very, very much.

Commissioner Everson, every time you hold that book up, I want to dive under the desk, since I did vote yes for the ETI.

Mr. EVERSON. I can tell you, I have not read it all myself.

Ms. MILLER. A little evening reading there. [Laughter.]

I think certainly a way that, in part your testimony articulated this, how we are ever going to get away from some of this paperwork burden is by using newer technologies. So I certainly applaud you with the e-filing and some of these kinds of things. In fact, actually before I got this job, I was the Michigan secretary of state where we have all the DMV there. We had gone in a couple of years period actually from having almost a 2-hour average wait time in our branch offices to about 5 minutes after we started initiating registration renewal by using technologies, fax, phone, Internet, etc. It's somewhat of an analogy to what you are trying to do there with e-technology, or e-filing.

Maybe you could flesh this out a little bit, some of the different efforts. You did talk about that a bit, but some of the efforts your agency has made to encourage that and how you can educate, I think particularly various demographics of our society. I sometimes say perhaps senior citizens are a little hesitant, although some of these studies say they are more on the Internet than anybody.

Mr. EVERSON. Yes.

Ms. MILLER. I think people who perhaps have a language barrier or some of these kinds of things might be hesitant to use the Internet or e-filing. How can we assist them?

Mr. EVERSON. I would make a couple of points here. Last year, a little shy of 62 million individuals filed returns electronically. That was something like 47 percent. This year, the filing season is not quite finished, we get something like 8 or 9 million returns that come in after the 15th for extensions. But we are well over 50 percent, we expect as time goes on we will still be over 50 percent, I think it's 66 or 67 million returns already filed electronically.

There are a couple of pieces of that. There are the pieces that come in, the portion that comes in from paid preparers. The fastest growth is the portions coming in from software where people are doing the returns themselves. They buy a product and bring it home and do it. The other thing that is grown very rapidly is something called the Free File Alliance. This is an initiative that John and I both worked on from OMB earlier, when the President's management agenda was launched to work on electronic government. Over 5 million returns have been sent in through a consortium of some 20 companies that provide free access to the Internet. You go to IRS.gov and then you pick a product and you can actually file your Federal return for free.

So that was set up to help middle income and disadvantaged folks and it's grown like a weed this is the third and final year of the initial launch on it. We are now going to renegotiate with these companies and I hope that it will stick around and continue to grow.

I have been surprised at the growth of the electronic filing. I thought it might peter out. It's just the opposite. It's become the way of doing business. There are beta sites, we have 14,000 beta sites around the country, they are using it. Lots of different play-

ers, all interact with communities. So we are not going to get everybody over time, but we are doing more and more this way. It is good. The refunds come in half the time. It cuts down on the need for these RALs, the refund anticipation loans that are a predatory practice by the preparers and others. This is all good for taxpayers.

Ms. MILLER. Just following up on that, you mentioned, I think, that there was a decrease in 5 million hours, I wrote that down, a reduction when you went from a threshold of \$50,000 to \$100,000. How do you determine even \$100,000, a sort of arbitrary number? Why not a million? How do you get to that number?

Mr. EVERSON. I think that what our folks do is they analyze, we have some pretty good data from our research people about who qualifies for what kinds of deductions or what is typical of a taxpayer that has \$100,000 of income or \$200,000 of income. Then you make a straight-out comparison as to who is more likely to qualify or not. And it's professional judgment that goes into that kind of a decision.

Ms. MILLER. Let me just ask you one more question here. Also, you were mentioning that you were looking at a pilot program or initiative where you would allow small businesses to file annually rather than quarterly. In one of my former lives, I also did the books in a family marina business. It was always such a pain to be doing that on a quarterly basis. We always said, well, the Government wants us to do this so they can get the float on our money rather than us having it.

So I really like the idea of going to an annual filing for some of the small businesses. In fact, you could even make an argument, I think, it's a tax cut for small businesses, besides the paperwork reduction burden and all these kinds of things. Where are you in the process with that?

Mr. EVERSON. I think it's 2 years away. Next year, pardon me, I'm corrected. We expect to get it in by next year. It's exactly the kind of thing that we like to do. And again, let me make the argument, for whatever we had with the new system, stability really helps you in an instance like this. Because the same people who have to design new forms are the ones who come up with the best ideas about simplifying things. If our teams of people are working on implementing the 173 provisions from this, they can only worry to a certain degree about where else they might simplify things.

So if we can get some stability in the system, maybe we can mine some more ideas like that. I know you have another panel, we get a lot of good ideas from small business groups and others about where to head with these. We're very receptive to that. We work with OMB, they provide a good frame of reference and hold us accountable as we do these efforts, as do you.

But give us a little breathing room here and I think we can do better.

Ms. MILLER. Great.

I'd like to recognize the ranking member, Representative Lynch, for his questions.

Mr. LYNCH. Thank you, Madam Chairwoman.

Commissioner, I realize that the electronic filing is on the increase. Are there certain areas where we have made it less likely

that people would file electronically? Are there certain types of returns that don't lend themselves to the way we have things set up right now, such as amended returns? Are those all non-electronic, and are we doing anything to increase the simplicity for people who have maybe there in that outlier group that is not currently coming into the electronic filing process?

Mr. EVERSON. I would say that the tear line is not within the family of individual returns. It is more importantly, the issue of corporations and non-individual filers. We are, as I indicated in my statement, we have mandated for corporations to file electronically next year, the larger corporations and the larger tax-exempts. Tax-exempts are a different animal, because there is total transparency there, as you know. Their annual returns are actually public. That is not the truth for corporations or individuals.

There is a tremendous savings in time, particularly for us, and the help of processing everything as you go that way. With individuals, what's happening now is as I indicated, practitioners more and more, they get on this bandwagon, you have somebody who prepares 50 or 100 returns, if they haven't done it, once they do it they never go back. I talk to practitioners, and the whole office goes electronic, they don't have as much paper any more in their offices.

But there are still some individuals who prefer to file by paper. I get letters, you mentioned the elderly, I get several letters a week from the elderly that share with me about some question and someone's been doing his or her return for decades and they still do it by hand. Usually it's a simple return. The more complex you get, the more complicated sources of income or rental income, the harder it is for people to do it by hand now of course.

Mr. LYNCH. I'm just wondering, the other part of this, and the Chair has already mentioned small businesses.

Mr. EVERSON. Yes.

Mr. LYNCH. And the burden, No. 1, on small businesses right now is significant.

Mr. EVERSON. Yes.

Mr. LYNCH. What have we done, it was already suggested about the time period for filing, but what are we doing now to help small businesses deal with their burden in filing?

Mr. EVERSON. This is a part of our—as you indicate, this is the bulk of the burden issue, if you will. We are constantly looking at things. We simplified the mileage deduction in the past year, where people could just take a standard rate for a higher number of vehicles than was the case before. We are always looking for opportunities here to increase the thresholds, if we have the latitude. Sometimes we don't. Or I would say we take ideas from the various groups, NFIB and others who represent small businesses.

What the IRS did 7 years ago, in 1998, was it reorganized under the new statute so that it is organized around four taxpayer groupings. One is small business and self-employed individuals. So we have a group within that organization that is constantly interacting with them and working to get these ideas and to make changes where we can. So it is an active part of the program that we run, the Burden Reduction Office is a part of that unit. It re-

ports directly to the Commissioner of the Small Business unit so it gets his personal attention, as it does mine from time to time.

Mr. LYNCH. OK. Thank you, Commissioner. Thank you, Madam Chairwoman.

Mr. EVERSON. If I could respond to one point that the ranking member made in your opening statement, we are committed to service. We believe strongly that we have a balanced program on services. We are doing some belt tightening here in line with the President's budget request.

But we believe particularly with the much higher level of services that we have on the phones that has been recovered over the years in terms of both access to our people and also an improvement in tax law accuracy, answering questions about the code, the complexities of the code, that we are getting a better result here.

I think you are referring to the closing of some of our walk-in centers. Those are the highest cost facilities that we have. You are also less likely to get the best answer there, because when you call on the phone, sir, you get routed to someone who knows about home office deductions or charitable contributions or whatever the issue may be. The subject matter expert, as opposed to when you walk into an office, you're dealing with an individual who then has to use more general knowledge and go to certain scripts as well.

But that is why we are doing this. GAO in fact has suggested that if you have to take cuts and balance your services, that the walk-in centers are a place to look, and that is what we have done.

Mr. LYNCH. Just in response to your statement, how was that determination made in terms of what offices get cut? I have heard them all over the country. So I know it is fairly widespread.

Mr. EVERSON. Yes.

Mr. LYNCH. I just want to know what the criteria were.

Mr. EVERSON. We expect to make this announcement, in fact, later this week. We used five broad categories, a couple were costs, employee costs, facilities costs. One was demographics, one was geography and workload was another. So we weigh things like how many EITC returns are there in the region serviced by the TAC, how close is the TAC to a beta center. As I mentioned, we have 14,000 beta centers around the country.

It is a whole variety of factors weighted more heavily toward taxpayer issues, if you will, in terms of volumes of the services, are there forms being asked for or is it tax law questions. It is actually 32 factors.

Mr. LYNCH. Madam Chairwoman, if I may, are we outsourcing any of this prep work? Is the IRS off-shoring it?

Mr. EVERSON. No. None of our work is off-shore. If you mean to other countries. That issue comes, it has been raised by Representative Markey. There are some preparers of returns that have had some of their work done overseas. That is not something we regulate directly. But we have said that we think in terms of transparency, anybody who is buying that service ought to understand, ought to know that is being done. But none of the work being done by the IRS under law can be done overseas. That is all done here.

Mr. LYNCH. Thank you.

Ms. MILLER. Closing these offices is your version of the BRAC, I suppose? Not looking for a comment there.

Mr. EVERSON. We would be lucky to get an up or down vote, a yes or no vote on this, I think. [Laughter.]

Ms. MILLER. Representative Souder.

Mr. SOUDER. Certainly Thomas Freedman's new book is going to raise this outsourcing outside the country question. Many of us strongly favor the ability to go to the private sector for collection and other types of things. But as it goes overseas, it becomes a little more complicated on privacy questions and legal questions.

I want to address, I brought a question. First off, and then narrow it in, as a case in my district, that you can get back to me on.

Mr. EVERSON. Yes, sir.

Mr. SOUDER. First off, I think there has been tremendous progress since I came in in 1994. I can tell over the last few years our case work, which many of our offices do, if it is not immigration, many of the others are either Social Security or IRS.

Mr. EVERSON. Right.

Mr. SOUDER. The ability to get back more rapidly on more cases and in a satisfactory way has been a pleasing change. In the first couple of years, it was hard. We have seen it more frequently. It does not mean everybody is always happy with it. But we have seen that improvement.

I use e-filing myself now. But it illustrates several of the problems, I know a witness on our next panel is going to talk about the home office. In many cases, like mine, my sisters and I have a partnership, so that is running through our personal returns, so we have to have that. My wife has a job at the house, so we go through this difficulty of how much of the desk can be deducted and how much of this section, how much of the energy bill, because she only works part-time at this job and it is only in one room of the house.

Clearly, one of the challenges that you face as is even pointed out in these regs, and yesterday in meeting with CPA people as they were up on the Hill, that complexity versus vagueness, the more complex the Code, the less vague it is, the more simple the Code is, the more vague it is and the more regulations you have to have to enforce it. That is part of our dilemma here. If we micro-manage and make huge, complex codes, then theoretically it is less vague.

But in the case that I have been dealing with for a couple of years, and it is important to my district, Napanee Ford, if you could have your staff look at the materials we gave you, because it illustrates a number of problems. It is clear on trucks, it is clear on trailers. I have the No. 1 RV manufacturing district in the United States, close to three-quarters of them are made there. There are vehicles that are used to pull smaller trailers. In fact, if you think in terms of elephant ears at fairs or people selling you lemonade at a fair or a hot dog, if you think in terms of gardeners who have these little white things that they pull behind them when they work on a lawn, the top 17 manufacturers of those are in my district, in addition to the RVs.

Many of the dealers around the country sell kind of in between not a Kenworth truck and not a pickup that haul these types of equipment around. I have one dealer in my district that is being hammered and being treated like a Kenworth truck, but his competitors are not. Part of the question is, how do you reconcile interpretation where you have a zone where Congress in fact is not nec-

essarily clear in the law, and that different IRS agents interpret this differently, which gives a competitive advantage to one dealer over another, not to mention I do not think, and if there is a clear change in policy, where all of a sudden this law is enforced at a given point, how we in Congress can then look at that as to whether we intended this to be addressed in that fashion.

Mr. EVERSON. You have covered a fair amount of ground there. First, I agree with what you said in terms of the general situation on the Code. It is a delicate balance between setting general principles or bright lines, bright lines are always helpful, but the more bright lines you set actually gives greater opportunity for the attorneys and accountants to find the little tear lines. It is a complicated question.

Returning to excise taxes, and I was briefed on this a little bit this morning, if you look at excise taxes generally they account for something like 3½ percent of the total revenue stream of the Government that it is the \$2.52 trillion we expect to take in this year, some \$70 odd billion. The excise taxes associated with trucks, I gather, are just a little over \$2 billion.

We did issue a new ruling that we felt clarified the standard here. It really relates to some of the vehicles that are now being used, as you say, to tow other vehicles. I guess this grew out of changes in recreational vehicles where they got larger and larger and then you had to basically have, I am told it is called a fifth wheel. I said what was that, and they gave me a picture of it.

So this is a change to a vehicle. The question is, is this a tractor or not. We have said that yes, this is.

Now, we issued those rulings, I gather this is a fairly new one last year, 2004, I think it is, in terms of enforcement, which is the second piece of your question. We select our audits based on either a generalized criteria, what we see on returns, or we do get leads. If your people in your district feel that somebody is getting away with something they should not get away with, please tell us that. We respond to leads like that.

The one part of your statement that I found distressing was the assertion that two different revenue agents would be interpreting the same set of facts differently. I am very concerned to hear that. We have trained people working on excise taxes. It is a relatively small group of people and I would imagine within Indiana it would be the same person or persons who are calling around here.

So I will raise that when I go back. We will followup on the cases you have raised. We do try to be consistent.

Mr. SOUDER. We will followup on how in effect a small vehicle got turned into a truck. But the second thing is, these vehicles are sold all over the United States.

Mr. EVERSON. Yes.

Mr. SOUDER. And the competition is all over the United States, and this particular dealer is right in the heart of the center, and may have been picked as an example to test the enforcement. What I believe is there ought to not be selective enforcement. It ought to be universal. We also need to know when there is a significant policy change that can affect a whole industry. Because this changes the nature of the cost of the vehicles that people purchase, to know there are going to be sudden excise taxes on hauling something

home that they did not believe was covered by the law previously. That is pretty much a policy change, to just having it be a simple reg change.

Mr. EVERSON. I think you could go back and forth as to whether it is a policy change or it is something that is reflecting a change in the industry where Detroit or your people who fabricate changes here make a very real change, because they are dragging along these much bigger recreational trailers and needed to redesign the vehicles. I am told here the question gets down to, do you disadvantage trucks ultimately of a certain size who may be paying the tax, and then if you exempt others, if you view the two operating together.

There is a lot of complexity here. I will check on the circumstances here. You are entirely right, if we are doing something that is specialized, we need to communicate it. People need to understand why we are doing it. I agree with that point as well.

Mr. SOUDER. It illustrates the danger in paperwork here, because I think it was 80 percent of the cases wind up, even as you reduce the paperwork, into these few cases that then drag on for years. In this case, yes, they have altered it, but we are talking 17,000 pounds versus 34,000 pounds on a Kenworth. It is more of a pickup on steroids, so to speak, although we are going to ban steroids. [Laughter.]

But an oversized pickup, and yes, there may be a few up here, and it is how do you distinguish between pulling a trailer for lemonade and elephant ears and a gardener from a huge almost full-size RV. That is what we are trying to work through.

I thank you for your indulgence with this. I thank the Chairwoman. It is a dilemma, clearly, in how you get tons of paperwork, because this has been generating a pile. This dealer is going around saying, I have all this paperwork with IRS. What happens is, when there is this type of change and how it is implemented is exactly how we get into these situations.

Mr. EVERSON. Sure. I appreciate your raising it. I have already told you more than I know. I will take it up when I get back to the office.

Ms. MILLER. Before we excuse you both, I have one question for Dr. Graham, I think, but perhaps both of you could answer it. I have been trying to understand the methodology that the IRS used, I think you used something called the A.D. Little. I am not quite sure if that is the right term, but the methodology that you use.

Dr. Graham, in your written statement, you were saying that there would be a one-time shift in estimated burden to the taxpayers when the IRS goes to a different kind of methodology. Perhaps you could enlighten me a little bit about what your thoughts are on that. One-time shift, which direction is the burden going to be going in, and hopefully in a positive trend line then, and then what is the timeframe for implementing that kind of analysis with the new methodology utilization?

Mr. GRAHAM. Thank you very much for that question.

We have been meeting quarterly with IRS on the development of their new model for estimating paperwork burden. I do not really know the answer to your question about what the overall direction of the effect will be. But one of the things that is very valuable

about the new modeling effort that they have put together is they will be able to look at paperwork burden and estimate by subgroups within both individuals and the business sector, so you can estimate changes due to regulation or policy on different segments of the tax-paying public.

This modeling investment they have made over several years is going to bring the measurement of paperwork burden at IRS in terms of quality considerably beyond what we have in all the other Federal agencies. I think that makes sense, given the 80 percent figure that you noted at the beginning of the hearing, 80 percent of this burden is at Treasury, mostly IRS.

Mr. EVERSON. I will just add one or two points on this. The old model, it really, I do not think it held water, because what it did, it just counted up the number of words and lines on a form. The new methodology, what it does is it looks at that, but then it also looks at the various attributes, is this going to result in more recordkeeping, is it going to result in calculations, it has something like 21 different attributes that are collected so that you make an overall calculation.

We have done that, it does show a spike up, a one-time adjustment. I think the piece for individuals went from 2.5 billion hours to 3 billion hours or something of that magnitude. So it is not insignificant. But it will really help us, as Dr. Graham has indicated, going forward, to have a much better calibration of impacts. It will take a while as we work. We have not used this on a form yet. As we go to work with OMB, there is some sort of indication that each form takes a certain amount of time. We have to now go through that process of updating those forms. So while we have an overall estimate, we will roll it through at greater levels of detail over the next, I think, 1 to 2 years.

Ms. MILLER. I will ask the ranking member if he has any additional questions.

Mr. LYNCH. Just one last one, it might be a loaded question. You mentioned earlier, Commissioner, about the real elephant in the room, so to speak, is the issue of tax reform. We continue in this exercise, and we are doing our best here, but at the end, ultimately maybe a better approach would be toward fundamental tax reform.

Excluding the whole issue of equity and all that, from a paperwork and efficiency standpoint, what in general terms would be the best approach to tax reform in terms of just addressing the narrow issue that we are talking about here today in terms of paperwork reduction and the simplicity of filing? Is it more of a consumption type arrangement or what are your thoughts on that?

Mr. EVERSON. That is a great question. One of the President's charges to the tax panel is to make sure that they look not just at the VAT or sales taxes, but that they look at the existing income tax scheme and reach a proposal there, along the lines of addressing just what you suggested.

When I testified before the tax panel in March, I mentioned a couple of things. There are numerous credits now. There is something like seven different educational credits. Really tough for somebody to figure out where they qualify for or where they do not qualify for. That is a reduction in complexity and burden.

There is the AMT that has received a lot of discussion. I think that is a burden. Somebody goes through a whole calculation, you get down to the bottom and we go, aha, we've got you. That is not your real tax, it is actually \$2,200 more. That is a form of complexity that breeds confusion, and I would suggest ultimately erodes respect for the law. Those are two areas.

I look particularly at corporate income tax. I do not think that is something that you worry about per se. I think you are thinking more of small businesses, the majority of which are organized, they are not incorporated, they are not C-corps. I am thinking about that in terms of the large corporations where complexity is now in this increasingly global world, it works against compliance for the IRS, people hide behind it.

I would like to see us reconcile this dynamic, this tension between the desire to increase book earnings, which drives shareholder valuations and decreased taxable earnings, because you get some incongruities there that are a function of complexity, which hurt compliance. Those are three areas I would mention.

Mr. LYNCH. Dr. Graham.

Mr. GRAHAM. Your question runs to the heart of one of the charges of the President's tax panel. It is going to be fascinating to see when they rank those various systems how they stack up, just as you say, in this narrow area but then weighing that against the other requirements.

Just to give a feel for the complexity of that, as I mentioned the tax benefit for school teachers in my oral statement, some simplified versions of the tax system will not have that benefit. So simplification may reduce paperwork, but it is going to draw some attention when those proposals come out.

Mr. LYNCH. Thank you. Thank you, Madam Chairwoman.

Ms. MILLER. I certainly want to thank both the witnesses today. We appreciate your time and consideration and your very thoughtful testimony as well. We will excuse our first panel and take a few minutes recess while our second panel gets themselves situated there. Thank you both very much.

[Recess.]

Ms. MILLER. We will call the hearing back to order. Next, the subcommittee will hear from Leonard Steinberg. Mr. Steinberg is the president of the Steinberg Group, which is a consulting practice that concentrates in the area of accounting, financial and administrative operations and taxpayer representation. He is also a member of the Small Business and Entrepreneurship Council. Mr. Steinberg is a former member of the Taxpayer Advocacy Panel, which is an organization created by the IRS that provides a forum for citizens to make suggestions regarding IRS decisionmaking.

Mr. Steinberg, we appreciate your coming today. We look forward to your testimony, sir.

STATEMENTS OF LEONARD STEINBERG, THE STEINBERG GROUP; KEITH HALL, HALL AND HUGHES, PLLC; AND LARRY GRAY, ALFERMANN, GRAY AND CO.

STATEMENT OF LEONARD STEINBERG

Mr. STEINBERG. Thank you, Madam Chairwoman, Mr. Lynch and I am sorry the other members of the subcommittee are not here. I thank you for the invitation to participate in today's hearing.

My testimony is based on my work with the Taxpayer Advocacy Panel and also my work, my professional work in my consulting and tax practices. Basically taxpayer burden really begins with enactment. Congressman Lynch, you had stated this very early in your remarks.

In my previous testimony to the Small Business Committee, chaired by Congressman Don Manzullo, I discussed the implications of tax law complexity and its associated disproportionate burden on small business. I look at this opportunity as to expand upon that testimony.

As an example, the revised W-4 form, which was put out for 2005, the information regarding the Paperwork Reduction Act is printed in extremely small print on page 2 of the form. The form states that the time needed to complete this form will vary depending upon individual circumstances. The estimated average time is recordkeeping, 45 minutes, learning about the law, 12 minutes, preparing the form, 58 minutes. For 2004, the estimated times for all of these were only about a minute longer for 2005, and yet all of this information is printed on the form for a minute more.

The total time for this form is 115 minutes, almost 2 hours. This form is a prime example of how burden is not reduced. From experience, both as a tax professional and someone who does consulting to small businesses, I know that learning about the tax laws associated with this form takes a great deal longer than the estimated 12 minutes.

In addition, there are many employees who require multiple W-4 forms due to changes in their personal circumstances and more often, when they work at second or even third jobs. The Government does not employ a measurement tool to determine the cost to small business employers in lost productivity. This lost productivity can only be made up by additional hours spent by the employer or passing the costs on to the consumer. This additional time affects the employer's quality of life and associated family issues as well, especially for the small business entrepreneur.

The Paperwork Reduction Act language on these forms states an average amount of time to correctly complete the forms. But these times are arbitrary, in my opinion, and based on the ability of the preparer. Once again, many small businesses must rely on paid professionals and their assistance in order to comply with the tax laws.

Now you have the issue of errors. When errors occur, the IRS must spend the resources to notify the small business that a correction is necessary. These additional communications add significant burdens to small business owners, since the letters sent by the IRS are difficult to understand. Once again, the business owner is re-

quired to pay for professional assistance in order to comply with the notices.

In measuring burden, the Congressional Joint Committee on Taxation scores tax law changes only for dollars and not for complexity on burden. This is a critical issue that Members of Congress must understand.

One issue that neither the Commissioner nor Dr. Graham mentioned which is in my written testimony is the burden the tax code puts on individuals in their State compliance. There is no connectivity or communication, satisfactory communication, between the IRS forms and the States. Therefore every State has developed its own system of taxation, whether it is for income tax or Federal unemployment. This only increases the burden on the small business taxpayer.

In my testimony I have given many additional examples of where the Taxpayer Advocacy Panel worked on issues directly related to paperwork reduction, and Michael Chessman is here from the office from which our committee worked on, and I am very appreciative of the work and support that Michael and his office gave us. But we analyzed issues of the payroll deposit penalties, the revised K-1, the Schedule D, the 940, and I listed in my written testimony approximately another 10 issues for which we were involved in.

In conclusion, I would like to say that the issue of burden on small business falls squarely with the domain of Congress. The IRS can only implement the will of Congress. The Paperwork Reduction Act, if it is not going to be done away with, it really should be modified to ease the burden on small businesses tax compliance. Remember, good intentions do not always lead to the expected outcomes. Thus we have the reality of unintended consequences. That is what the small business community is experiencing—the unintended consequences of the burden of all of this additional work that has to do in order to maintain compliance.

Thank you.

[The prepared statement of Mr. Steinberg follows:]



**Prepared Statement of
Leonard Steinberg, EA, CMC
The Steinberg Group
On behalf of the
Small Business & Entrepreneurship Council**

On

**Paperwork Reduction Efforts of the
Internal Revenue Service**

Before the

**Subcommittee on Regulatory Affairs
Committee on Government Reform
U.S. House of Representatives
Candice S. Miller, Chairman**

May 25, 2005

Chairman Miller and members of the House Subcommittee on Regulatory Affairs, thank you for the invitation to participate in today's hearing to examine the impact the tax system paperwork burden has on the small business community and whether the Internal Revenue Service's processes for implementing policies and standards that reduce the government paperwork burden, as mandated by the Paperwork Reduction Act of 1980 (and as amended), are beneficial to small businesses.

My name is Leonard Steinberg. I am an Enrolled Agent and a Certified Management Consultant. I am the president of The Steinberg Group, a West Windsor, New Jersey consulting practice that concentrates in the areas of accounting, financial and administrative operations, taxpayer representation before the Internal Revenue Service, and Board of Directors development for nonprofits and small businesses. I am a member of the Small Business & Entrepreneurship Council (SBE Council), who I represent today, a national, nonpartisan organization whose advocacy efforts work to protect small business and promote entrepreneurship.

I was a member of the Taxpayer Advocacy Panel (TAP) and chair of the committee on Small Business/Self Employed Payroll tax from 2002 through 2004. Prior to this position, I was a member of TAP's predecessor, CAP, for one year, from New York. Our TAP committee was charged with researching and recommending policies and procedures for reducing taxpayer, (i.e. small businesses), burden with respect to accurate and timely filing, reporting and payment of payroll taxes. During this period of time, our committee reviewed the current IRS documentation and made specific recommendations to reduce burden on small businesses.

This testimony is based on our TAP committee's findings and observations and on my professional consulting and tax practices.

Burden:

Taxpayer burden begins at enactment. In my previous testimony to the Small Business Committee, chaired by Congressman Donald A. Manzullo, I discussed the implications of tax

law complexity and its associated burden on small businesses. This burden is directly related to the forms and publications printed by the IRS.

As an example, on the revised W-4 form (Employee's Withholding Certificate) for 2005, the information regarding the Paperwork Reduction Act is printed in very small print on Page 2 of the form. The forms states, "The time needed to complete this form will vary depending on individual circumstances. The estimated average time is: Recordkeeping 45 min.; Learning about the law or the form, 12 min.; Preparing the form, 58 min." For 2004, the estimated times for Recordkeeping, Learning about the law or form and Preparing the form, were only 1 minute longer than for 2005.

The total time for this form is 115 minutes, almost 2 hours. This form is a prime example of how burden is not reduced. From experience, I know that learning about the tax laws associated with this form take much longer than the estimated 12 minutes.

In addition, there are many employees who require multiple W-4 forms due to changes in their personal circumstances or more often for working at second jobs.

The government does not employ a measurement tool to determine the cost to the small business employer in lost productivity. This lost productivity can only be made up through additional hours spent by the employer or passing on the costs to the consumer. This additional time affects the employer's quality of life and associated family issues, as well.

The Paperwork Reduction Act language on the forms states an average amount of the time required to correctly complete the form(s). These times are arbitrary and based on the ability of the preparer. Once again, many small businesses must rely on and pay for professional assistance in order to comply with the tax laws. Many small businesses do not have adequate budgets and funds to pay for professional help. This only increases the burden and the probability that errors of omission and co-mission will occur.

When errors occur, the IRS must spend the resources to notify the small business that a correction is necessary. These additional communications add significant burdens to small business owners since the letters sent by the IRS are difficult to understand. Once again, the small business owner is required to pay for professional assistance in order to comply with the notice(s).

The TAP Committee on Notices worked with the Notice Process Initiative Team to recommend changes. Currently the multiple notices cause confusion to the recipients. The revised notices would provide enough detail and explanation for the small business to prepare for follow-up action. The IRS could realize cost savings and staffing demands by reducing the need to maintain obsolete programming and procedural guidelines.

As tax law and its enactment remains complex, the small business owner is forced to rely on professionals to assist with the timely filing, reporting and payment of all prescribed taxes. These additional costs are either passed on to the consumer or deducted from the small business owner's ability to pay himself/herself an adequate wage or give well-earned raises to the employees.

In this case, the Paperwork Reduction Act does not reduce burden on small business employers. Compliance only increases the amount of time small business employers must expend. According to the Small Business Administration's analysis, small firms with fewer than 20 employees spend 60 percent more per employee than larger firms to comply with federal regulations. Small firms spend twice as much in dollars on tax compliance as their larger counterparts.

The IBM Company prepared a report to the Internal Revenue Service, dated February 17, 2004. The report was the Final Report on Qualitative Research for the Small Business Taxpayer Burden Study. The report is replete with examples of burden on the small business taxpayer.

Measuring Burden:

Currently, the Congressional Joint Committee on Taxation scores tax law changes only for dollars and not for complexity or burden. The IRS does not know how to measure burden. There are no statistical models used by either the Joint Committee or the IRS to determine the extent of the burden imposed on small business.

The Joint Committee and the IRS can only measure the effect of any tax law. The Joint Committee and the IRS rely on professional organizations outside of government to provide additional data on the implied costs to small business. This is accomplished through hearings such as this and position papers on proposed legislation.

In the IRS Strategic Plan for 2005 – 2009, the heading on Page 17 of the document states, “How We Will Measure Success In Improving Taxpayer Service.” One of the measures mentioned is burden reduction. The document states that success through burden reduction will entail, “measurements of time and out-of-pocket expense taxpayers incur in meeting their tax responsibilities.” The document does not state nor explain the methodology the IRS will implement to complete this task nor what the IRS will do with their findings.

Unless there is a concerted effort to effectively and correctly, statistically and financially, measure the costs associated with burden, the small business community will continue to bear the disproportionate share of burden in order to comply.

States’ Burden:

Our TAP committee was directed to analyze and propose a methodology by which the IRS could capture tax payments and Federal Unemployment Insurance and remit the payments and related information to the respective state processing centers. After extensive effort, our committee concluded that there was no practical method to accomplish the IRS request. Our committee found out that the IRS does not have the best reputation among the states. Therefore, each state

requires its own statutory process for filing, reporting and payment of income tax and/or Federal Unemployment tax.

The states taxing authorities have their own processes and methodologies and do not follow federal regulations. Therefore, this increases the burden on small businesses. Each small business is required to file separate returns. This increases the amount of paperwork required. It also increases the amount of time the small business owner must spend on paperwork allocated to federal and state tax law compliance. As with the issue of tax complexity, these additional burdens decrease productivity and negatively impact the daily business process.

If the objective is to reduce paperwork, this objective has failed. The small business community still spends a disproportionate share of resources (time, personnel and dollars) in order to comply with the regulatory process.

Additional Examples:

Our TAP Committee analyzed the issue of Payroll Deposit Penalties. Our findings were that the information and instructions were confusing and hard to follow and there were too many levels of deposit penalties. Our recommendations to our Issue Owner included a restructuring of the entire Payroll Deposit Penalty process and a reducing the number penalties and categories.

The IRS instituted a matching process for the revised K-1 form. This form is used by small businesses (S-Corps), partnerships, and estates and trusts to convey financial and tax information related to the individuals return. The complexity and completion of these forms increases burden due to the complexity and changes in tax law.

Schedule D is used to delineate financial instrument transactions (e.g. stocks, bonds, etc.). The IRS does not currently accept a roll up log for active traders (e.g. day traders). However, roll up activity is acceptable for charitable donations. The IRS states that the reason the Service requires complete Schedules D is that the information is used for research purposes. Once again, the preponderance of responsibility falls to the small business community.

The IRS recently changed Form 940 (Employers Federal Unemployment Tax Return) filings to quarterly from monthly. The problem is that small businesses may find uses for that money and inadvertently forget to file, report and pay timely. The IRS will generate late notices to the small business owner. These received notices require additional resources of time, effort and money, to reply to the notices. In many instances, penalties and statutory interest are added to the amount the small business may have to pay.

The Taxpayer Advocacy Panel issued its Annual Report, dated December 31, 2004. The report specifically mentions TAP involvement with the IRS and forms and publications. TAP made recommendations for improving the forms and procedures. A partial list includes the following:

- a) Offers in Compromise – Form 656 – clarifying comments and instructions
- b) Revisions to Form 6251 – Alternative Minimum Tax
- c) Form 2848 – Revision to the Power of Attorney
- d) W-4 – Employer/Employee Withholding
- e) Notice Standardization Guide
- f) Forms and Instructions Testing
- g) Form SS-4 – Employer Identification Number
- h) Language Standardization on Notices
- i) Form 1041 – Estates and Trusts
- j) EFTPS – Clarifying Instructions

It is evident from this list that the IRS needs assistance in helping to reduce burden. The IRS prints and distributes Publication 4109, Office of Taxpayer Burden Reduction. This publication specifically explains taxpayer burden and how the public can assist. The publication clearly states, “...IRS doesn’t have the ability to change existing tax laws; proposals involving legislative changes should be submitted to congressional representatives.”

Conclusion:

In 1980, the year the Paperwork Reduction Act was passed into law, the number of instruction booklet pages for the individual form 1040 was approximately 45 pages and the form itself

contained 68 lines. In 2004, the number of instruction booklet pages for the individual form 1040 was 128 pages and the form itself contained 75 lines. Burden has significantly increased in the last 25 years.

The issue of burden on small businesses falls squarely within the domain of the Congress. The IRS can only implement the will of the Congress. The Paperwork Reduction Act should be modified to ease the burden on small business tax compliance.

Recommendations:

- 1) Reduce tax law complexity. The continued complexity of the tax law and the forms continues to exact enormous burdens on small business and taxpayers.
- 2) Improve the documentation the IRS provides to small business. The forms should be written clearly and definitively. The forms should be easy to complete.
- 3) Do not close the Taxpayer Assistance Centers. These centers are very useful to small businesses. These centers allow small businesses to ask for assistance with completing forms, filing, reporting and paying taxes timely.
- 4) Require that the IRS demonstrate, with specific examples and by specific deadline dates, to this committee, that the IRS is complying with the letter and the spirit of the Paperwork Reduction Act.
- 5) Require that the IRS work with the Taxpayer Advocacy Panel to maintain a standing committee dedicated to reducing small business and taxpayer burden regarding all forms, publications and notices.

I sincerely thank you for the opportunity to address this Committee. Chairman Miller and members of the Committee, I look forward to our dialog and your questions on this issue.

Thank you.

Ms. MILLER. Thank you very much. The subcommittee is going to hear now from Mr. Keith Hall. Mr. Hall is a member of Hall and Hughes. He is a CPA and also a member of the National Association for the Self-Employed, which is the Nation's leading resources for the self-employed and micro-businesses. Mr. Hall also participates in the NASE Tax Talk Service, where he answers specific personal questions for thousands of small business owners every year.

Mr. Hall, we appreciate your attendance at today's hearing and look forward to your testimony, sir.

STATEMENT OF KEITH HALL

Mr. HALL. Thank you very much, Chairwoman Miller, Ranking Member Lynch. I appreciate the opportunity to be here today, both as a small business owner and as a member of the National Association for the Self-Employed.

As such, I represent the over 250,000 NASE members and more broadly, the 18 million micro-business owners which are those that employ less than 10 people. In 1980, lawmakers much like yourselves recognized the increasing burden of Government regulations and paperwork on all businesses and passed the Paperwork Reduction Act of 1980. This act, and its expansion in 1995, have had a positive impact on what we are discussing here today. But I don't think the job is finished, especially for small business owners.

Even after the efforts of the last 25 years, the Small Business Administration estimates that a small business owner incurs about \$7,000 per employee per year just to keep up with taxes, paperwork, reporting requirements. For many, this is like paying for another employee that never shows up for work.

Further, the IRS estimates that taxpayers will spend about 19 hours completing their 2004 tax return. For a small business owner with a Schedule C, they will spend more time than that.

There are certainly a lot of numbers that we can throw around. But the key point is that regulatory compliance and excess paperwork is still an issue for small business owners like me. Now, I know we're here to talk about paperwork reduction and not paperwork elimination, so hopefully there is a medium somewhere that we can find. In fact, during the last 5 years, the IRS has made a tremendous effort and had success in helping small business owners like me in managing the nightmare that is called the Internal Revenue Code.

Their education and outreach efforts and their work within their Office of Burden Reduction has been very good. Their commitment to their Web site and availability of forms and information online has been exceptional. The changes that Mr. Everson mentioned on threshold requirements, of the ability to file a 1040A up to \$100,000, those things are a tremendous help to small business. And I wanted to make it clear to the IRS that small business does appreciate their efforts, especially since I haven't gotten my refund yet. [Laughter.]

Really, they have done a great job. But again, I don't think the work is done. It is very easy to generalize about the problem and then kind of sit back and hope somebody else can fix it. So please allow me to be specific, both to issue and to solution.

Many small business owners operate out of their home and most likely qualify for home office deduction. But many lose that deduction just because they can't handle the form. They have to know the difference between indirect expenses and direct expenses, what type of mortgage interest they have, there are two different lines for casualty losses, and as I mentioned in my written testimony, on the one-page form, the words "see instructions" appear 16 times, just on the form.

A solution would be to provide a standard deduction for the use of a home office. The form could be two yes or no questions and then pick a number from a chart. The net deduction would be about the same, the net tax impact would be about the same, but the taxpayer would save 2 hours and probably two Advil.

Another example is the current confusion related to worker classification. The small business owner knows they use an individual to help in the business, but they don't know if it is an employee or an independent contractor. The IRS has a 20 point checklist to help, but many of those items are subjective, and it is difficult to get to a yes or no answer.

The solution is to simplify the process for identifying who is an employee and who is not an employee. Developing a clear set of rules will help all employers make the right decision on who is an employee and who is not.

There are a lot of other examples to talk about, but again, the common thread is the overall complexity of both the Internal Revenue Code and the paperwork required to maintain compliance with that Code. The sheer volume of the forms and related calculations can be overwhelming. This is particularly true for the small business owner, since they do not typically have the same access to accountants, attorneys and other professionals that big businesses do.

I believe that the most immediate solution is to continue to strengthen the Paperwork Reduction Act and the Office of Information and Regulatory Affairs. Expanding OIRA with more funding and more staff would make sure that the efforts continue. Expanding the oversight authority of OIRA is also critical. Currently the IRS is not subject to the review process of OIRA, so that the biggest paper eater of all does not have the same rules that other agencies do.

Additionally, the IRS Office of Burden Reduction should have more funding and staff as well. This office has done a very good job, as I mentioned, in helping redesign and simplify many tax forms, but the job is bigger than they are.

On behalf of the NASE and for me personally, it is my request that this subcommittee continue in the spirit of the Paperwork Reduction Act and in promoting the efforts of OIRA to reduce the burdens of regulatory compliance on small business. Every hour that is not spent filling out a form can be spent creating a new job. And I believe that's what small business is all about.

Thank you very much.

[The prepared statement of Mr. Hall follows:]



National Association for the Self-Employed

NASE Legislative Offices • 1200 G Street, NW, Suite 800 • Washington, DC 20005
Phone: 202-466-2100 • Fax: 202-466-2123 • www.nase.org

Testimony of

**Keith Hall, CPA
Hall & Hughes, PLLC**

**On behalf of the
National Association for the Self-Employed**

**Subcommittee on Regulatory Affairs
House Committee on Government Reform
“Paperwork Reduction Efforts of the Internal Revenue Service”**

May 25, 2005

“The nation's leading resource for micro-businesses and the self-employed”

I would like to express my appreciation to Chairman Candice Miller, Ranking Member Stephen Lynch and the members of this Subcommittee for the opportunity to participate in today's hearing. I am here to testify on behalf of the National Association for the Self-Employed (NASE) and our 250,000 member businesses, representing over 600,000 owners and employees nationwide. The NASE is the nation's leading resource for the self-employed and micro-businesses, businesses with ten or less employees. Today, this vital segment of the small business population is a key driver of America's economic engine and numbers more than 18 million.

Often, the chief speed bump faced by micro-business owners on the road to their success is a collective \$800 billion dollar bill called federal government regulation. And because big successes usually have small beginnings, these costs loom large to micro-businesses, which are capitalized chiefly on dreams and ideas.

The NASE is a strong supporter of an effective, viable Paperwork Reduction Act. This Act, through its authorization of OMB's Office of Information and Regulatory Affairs (OIRA) to review regulations issued by federal agencies, aims to ensure that micro-businesses are not subjected to unreasonable regulations and paperwork. Unfortunately, federal agencies have diluted or worked around this law and continue to issue burdensome regulations without adequately looking at the effect they have on small business. Paperwork for micro-businesses continues to increase and have a detrimental affect on the ability for the self-employed to successfully manage and grow their business. These businesses do not have human resource departments filled with accountants, attorneys or benefits administrators. The self-employed administer every aspect of their business and thus, the time spent addressing onerous regulations is time away from their business.

A report sponsored by the U.S. Small Business Administration entitled "The Impact of Regulatory Costs on Small Firms," cited that firms employing fewer than 20 employees face an annual regulatory burden of \$6,975 per employee. This same report cited that tax compliance issues are particularly burdensome to small business. As a self-employed certified public accountant for 15 years and as a tax consultant for the National Association for the Self-Employed's TaxTalk program, I am in the unique position of conveying to you both my

perspective as a business taxpayer as well as that of a tax professional regarding the regulatory and paperwork burden the IRS places on the self-employed and micro-business.

Let me begin by stating that as a CPA I have been very pleased with the efforts made by the Internal Revenue Service over the past few years to become small business friendly. Positive changes have arisen through the IRS's enhanced outreach and educational efforts as well as their work in the Office of Burden Reduction to simplify and minimize paperwork. Their commitment to their website and the availability of information has been very good and certainly recognized by the NASE and many small business owners.

However, despite steps toward improvement, the IRS in 2005 has estimated that taxpayers will have to spend on average over 19 hours filing a 2004 individual income tax return (Form 1040) and the associated Schedule A. Also, according to a 2001 study conducted by the Joint Committee on Taxation, at that time a taxpayer filing an Form 1040 could be faced with 79 lines on their return, 144 pages of instructions, 19 separate worksheets as well as the possibility of filing numerous other forms. With over 1.4 million words, the tax code is so convoluted that is extremely difficult for both taxpayers, tax practitioners and the IRS to reliably and accurately comply with or enforce the breadth of tax regulations. Minimizing the complexity of the tax code and paperwork burden faced by small business is one solution that policymakers and taxpayers alike have endorsed.

Through the National Association for the Self Employed TaxTalk service we answer specific personal questions for thousands of small business owners every year. As you might expect, a vast majority of those questions are based on a lack of understanding of some specific point related to their tax compliance. I feel that there are key areas in the tax code that the IRS can address which would greatly minimize the burden on the self-employed.

Home Office Deduction

Increasingly, entrepreneurs are utilizing their home as a primary place of business. According to research commissioned by the SBA Office of Advocacy, home-based businesses represent 52 percent of all firms and provide 10 percent of the total revenue of the economy. Many home-

based business owners do not make use of the home office deduction due to the complexity of the deduction and stringent criteria they must meet.

The form for the home office deduction is very complicated. The taxpayer must differentiate between direct and indirect expenses and also between deductible mortgage interest and excess mortgage interest. Some of the expenses are deductible even if the business has a loss and some aren't. Some casualty losses go on line 9 and some go on line 27. The words "see instructions" appear on this one page form 16 different times. Those instructions say the form will take an average of 1 hour and 15 minutes to complete. The form may be as simple as possible which may indicate that the code is too complicated. The best option for paper work reduction is to concentrate on tax code simplification. A standard deduction for the use of a home office is an excellent example. Providing a tiered deduction based on national averages could save an hour and 15 minutes for many small business owners.

Worker classification regulations

Another specific IRS regulation that is exceedingly burdensome to the micro-business and self-employed communities is the employee vs. independent contractor classification. Many NASE members either utilize independent contractors or are themselves independent contractors. Disputes about who is an employee and who is an independent contractor have cost small businesses more than three-quarters of a billion dollars in IRS penalties and back-taxes during the past 10 years.

The IRS has a complicated 20-point checklist that can be used as a guideline in determining whether or not an individual is an employee or an independent contractor. Yet, using this checklist does not guarantee that a person is correctly classified. Other IRS materials published to assist in classification are equally as convoluted. NASE Members have indicated when utilizing the I.R.S.'s tax assistance help line on this issue, they have gotten different answers from different agents on this same issue. A large issue is that there is no one, single, homogenous definition of the term "employee." Thus, there is no clear and concise manner for a self-employed individual or micro-business owner to easily determine when an individual should be classified as an independent contractor or an employee.

With more and more individuals conducting a business out of their home as "independent contractors" and the economic incentive to employers to use independent contractors rather than employees, the issue of worker reclassification continues to be a key area for the recovery of revenue by the IRS despite its recent efforts to become more small business friendly. Due to the vagueness of existing regulations and their complexity it is very easy for the IRS to arbitrarily reclassify workers and thus, require micro-business owners to pay enormous sums of back taxes and penalties, which can ultimately force them out of business.

The NASE strongly feels that the IRS regulation must be updated to provide straightforward rules for classifying workers and relief from reclassification. A clearly defined set of rules for classification of workers would provide certainty for businesses that enter into independent-contractor relationships, and minimize the risk of huge tax bills for back taxes, interest, and penalties if a worker is misclassified after the parties have entered into an independent-contractor relationship in good faith.

Deduction for Business Use of Personal Automobile

Many self-employed individuals use their personal automobile in the business but don't know how to include that cost on the tax return. They are told that they can fully deduct the cost of the vehicle, but later find out that is true only if the car weighs over a certain number of pounds. Later still they find out the limit is different for SUVs. The IRS has simplified this process with the use of the standard mileage rate. Many small business taxpayers utilize this approach mainly because it is indeed simpler. However, choosing the approach that they can best understand may not be the best tax or business decision for their situation. If they indeed qualify for the section 179 deduction, they can no longer use the standard mileage rate. This is another opportunity for the standard deduction calculation. Having a tiered deduction based on the value of the vehicle in addition to the standard mileage rate for future years would help the small business owner maintain a level playing field with bigger business that have the resources to keep up with the additional reporting requirements. Providing the benefit based on specific fact situations without requiring the completion of additional paperwork will help small business, reduce the level of paper required and would not change overall tax revenue.

Other Suggestions to Relating to the Internal Revenue Service

The NASE encourages Congress to strengthen the Paperwork Reduction Act, most especially the Office of Information and Regulatory Affairs. We believe that OIRA should receive more funding for additional staff and regulation/data review efforts. In addition, the office's oversight authority over independent agencies should be expanded. For example, at the present time the Internal Revenue Service is now chiefly exempt from OIRA oversight. This is a critical impediment to the fulfillment of the goals of OIRA considering that the IRS is the agency whose regulations and paperwork have the most burdensome and widespread affect on small business.

In addition to allowing OIRA some oversight of the IRS, we feel that within the IRS the Office of Taxpayer Burden Reduction should be strengthened through additional funding and staff. This office is responsible for simplifying forms and publications, promoting less burdensome rulings and regulations and streamlining internal IRS policies and procedures. This office has been able to have some significant successes in minimizing and clarifying tax forms and regulations. However, we feel this office is understaffed and under funded to adequately address the extensive scope of IRS regulations.

Conclusion

In conclusion, the ultimate hardship that is faced by the self-employed and micro-businesses when dealing with federal agencies is the complexity, vagueness, and at times redundancy of regulations they issue. The simple difficulty of understanding and then complying with any and all regulations affecting their business is overwhelming for a micro-business owner. This burden imposed on micro-business is disproportionate to that of larger businesses because smaller firms cannot spread the overhead costs associated with hiring accountants and attorneys, and the general cost of paperwork burdens and staff needed to try and comply with the maze of federal regulations.

Thus, we must do a better job through the Paperwork Reduction Act and OIRA to ensure that regulations, specifically those promulgated by the Internal Revenue Service, are reviewed prior to finalization to determine their economic impact and burden on small business. In addition, the

IRS must work harder to minimize and simplify paperwork as well as revise unfair and onerous tax regulations.

Ms. MILLER. Thank you very much.

Our next panelist this afternoon is Larry Gray. Mr. Gray is the managing partner for Alfermann, Gray and Co. He served on the IRS Commissioner's Advisory Group from 1992 to 1994 and various subcommittees as well, including compliance and small business. Mr. Gray is also a member of the National Association of Tax Preparers.

Mr. Gray, we appreciate your coming to Washington. We certainly look forward to your testimony as well, sir.

STATEMENT OF LARRY GRAY

Mr. GRAY. Thank you, Madam Chairwoman, and Ranking Member Lynch.

As I go into my remarks, my remarks are based on being a practitioner in the field. But also currently, I am on the Electronic Tax Administration Advisory Council. Then on a monthly basis, as the Commissioner referred to earlier, we are one of the groups that meets in Washington with the Small Business, Self-Employed, National Public Liaison. So my views today, as my two predecessors, they spoke more on specifics and looking at paper. What I would like to do is do a little different twist. I do get the opportunity to look at the burden reduction through Michael Chessman's office, and I believe that's doing a very good job.

But I want to put a flavor on more of the technology, where we need to move to. With that, my first comment is on the Paperwork Reduction Act. I believe it has failed its purpose. In my written report, I cite some of the same numbers that you started out today with, Madam Chairwoman. So in order to not take time there, I want to move on and look at some of the failures.

The first one I would like to look at is that the failure of the Paperwork Reduction Act can be attributed in large part to the law changes in the recent years and because of the additional forms, instructions, administrative pronouncements, rulings that are required to implement that new law. Also if you look in my written report, you can see that the implementation of the last two major law changes in 2001 and 2003 resulted in additional burden hours of 330 million and 113 million respectively.

Now, I would like to describe areas that need reform. I am going to look specifically at e-file, form management, documentation requirement, IRS communications and record retention. The e-filing allows taxpayers to file taxes electronically instead of by paper. The system not only saves paper but is more efficient for both the taxpayer and the IRS. It is estimated that if the e-filing system accommodated all taxpayers, the paperwork caused by tax preparation would be slashed by a third.

But the current e-filing system has flaws that decrease its usage. For example, a taxpayer with an amended tax return, a taxpayer with more than one form 2106 to report unreimbursed employee expenses, cannot e-file. Moving all return types to one platform, XML platform, would resolve many of the e-file issues. Along with that, the continued development of e-pay, e-services, would move us more to a transparent e-system.

Another area that needs improvement is form management. The sheer volume of forms is startling. The National Taxpayer Union

policy paper 110 states that the IRS now prints over 1,100 publications, forms and instructions that total over 16,300 pages in length. Taxpayers and tax professionals are hindered by the vast amount of time required for forms, spending considerable amounts of time reading instructions and publications to determine the proper way to complete the required form.

Form management could be accomplished by eliminating forms that are not necessary for the effective administrative of the tax laws. An example includes the forms that require taxpayers who wish to get an automatic extension of time to file their tax return. Currently, form 7004 is required for corporations, the 4868 for individuals and form 8736 for partnerships and trusts. Why are these forms required when these extensions are automatic and require no IRS approval?

Another area for improvement would be the reduction in documentation required to be filed when the IRS already has the information that is being submitted. To illustrate, when an amended tax return is filed, the taxpayer submits not only form 1040X, but a copy of the original, which is wasteful.

The IRS communications with taxpayers need to be changed. Taxpayers receive notices that are triggered automatically and result in a taxpayer receiving a notice just after they have responded to a notice sent earlier. The automatically triggered notice requires a taxpayer to respond again, and results in more paper and time wasted for the taxpayer.

Taxpayers who participate in offering compromises are often asked to submit the same information multiple times. IRS communication could be vastly improved if a two-way system of communications via e-mail were implemented as a communication channel. And I really stress the two-way. If you have it electronically, then don't put it back to paper. E-file would facilitate faster responses to the taxpayer inquiries and would be an effective method for the taxpayers to contact the IRS.

Another area of change is in the area of record retention. Currently, taxpayers are advised to keep copies of original tax returns for 6 years. Practitioners are required to keep them for 3 years. And then when we go and look at audits in order to support documentation there, it can be many years. A more practical approach would be to place the burden of storage on the IRS, since they already retain the information anyway.

Paper burden has also been a cause for the sheer complexity of the Tax Code. While the hope is that the Presidential tax force will make proposals for simplification, there is much to be done in the interim.

While the time I have to speak is limited, there is much more that could be communicated on this topic. I have only been able to speak to a few of the more pressing issues. I thank you for the time and consideration of my comments, Chairwoman Miller and Ranking Member Lynch. I look forward to our dialog and to your questions on this issue. Thank you.

[The prepared statement of Mr. Gray follows:]



**Prepared Statement of
Larry Gray, CPA
Alfermann Gray & Co.
On behalf of the
National Association of Tax Professionals**

On

**The Paperwork Reduction Act and the
Burden of Paperwork on Taxpayers**

Before the

**Subcommittee on Government Reform Regulatory Affairs
U.S. House of Representatives
Candice S. Miller, Chairwoman**

May 25, 2005

**National Association of Tax Professionals · PO Box 8002
Appleton, WI 54912-8002 · 800.558.3402 · www.natptax.com**

Chairwoman Miller, Ranking Member Lynch, and Members of the House Government Reform Regulatory Affairs Subcommittee, thank you for the invitation to participate in today's hearing to examine the implications of the Paperwork Reduction Act and the burdens placed on taxpayers.

My name is Larry Gray and I am the managing partner of Alfermann Gray & Co. I have served on the IRS Commissioner's Advisory Group from 1992 until 1994 and various Subcommittees, including Compliance and Small Business.

The Paperwork Reduction Act has largely failed its purpose as evidenced by the following statistics. According to the U.S. General Accounting Office, the annual paperwork burden imposed by the federal government was 7.4 billion hours for fiscal year 2000 and by the end of fiscal year 2003, the burden had increased by nearly 10%, accounting for 8.1 billion hours.

The burden associated with the excessive paperwork hits taxpayers and tax professionals particularly hard. The U.S. General Accounting Office estimated that the Internal Revenue Service accounts for more paperwork hours than any other federal agency, accounting for 81% of the total hours each year.

Failure of the Paperwork Reduction Act can be attributed in part to the tax law changes in recent years and the additional forms, instructions, and administrative pronouncements and rulings required to implement the new laws. According to U.S. General Accounting Office estimates, taxpayers spent an additional 330 million hours filling out tax paperwork in fiscal year 2002 due to the implementation of the Economic Growth and Tax Relief Reconciliation Act of 2001 and other IRS regulations. The Jobs and Growth Tax Relief Reconciliation Act of 2003 generated an estimated 113.9 million additional hours of burden to taxpayers according to IRS Commissioner Mark W. Everson.

Improvements to the current system would provide some much needed relief to weary taxpayers and tax professionals alike. I will now describe areas in need of reform such as e-filing, forms management, documentation requirements, IRS communications, and record retention.

E-filing allows taxpayers to file taxes electronically instead of by paper. The system not only saves paper but is more efficient for both taxpayers and the IRS. It

is estimated that if the e-filing system accommodated all taxpayers, the paperwork caused by tax preparation would be slashed by one-third. But the current e-filing system has flaws that decrease its usage. For example, taxpayers with amended tax returns and taxpayers with more than one Form 2106 to report unreimbursed employee expenses cannot e-file. Moving all return types to one platform, xml, would resolve many of the e-file issues.

E-filing Forms 940 and 941 requires taxpayers to incur additional costs not incurred with paper filing. Imposing such costs discourages taxpayers from utilizing the e-filing option which compounds the problem of the paperwork burden.

Another area in need of improvement is forms management. The sheer volume of forms is startling. David Keating of the National Taxpayers Union in NTU Policy Paper 110 stated that the IRS now prints over 1,100 publications, forms, and instructions that total over 16,300 pages in length. Taxpayers and tax professionals are hindered by the vast amount of required forms and spend considerable amounts of time reading instructions and publications to determine the proper way to complete the required form.

Form management could be accomplished by eliminating forms that are not necessary for the effective administration of the tax laws. Examples include the forms that are required for taxpayers who wish to get an automatic extension of time to file their tax returns. Currently Form 7004 is required for corporations, Form 4868 for individuals, and Form 8736 for partnerships and trusts. Why are these forms required when these extensions are automatic and do not require IRS approval?

Additionally, separate forms exist that could be combined into one form to help simplify matters for taxpayers and the IRS. For example, Forms SS-4, 8832, and 2553, could be combined into a single form which would allow new businesses to request their taxpayer identification number and elect their entity classification in one easy step.

Another area for improvement would be reduction in the documentation required to be filed when the IRS already has the information that has to be submitted. To illustrate, when an amended tax return is filed, the taxpayer submits not only Form 1040X but also a copy of the original which is wasteful.

Forms are also designed in such a way that multiple forms are required if taxpayers have multiple properties. For example, if taxpayers own multiple rental properties, each rental property requires its own Form 4562 to report depreciation. This is but one example where extra forms are needed but do not further the administration of the tax laws in any way.

IRS communications with taxpayers need to be changed. Taxpayers receive notices that are triggered automatically and result in taxpayer receiving notices just after they have responded to a notice sent earlier. The automatically triggered notice requires the taxpayer to respond again and the result is more paper and time wasted for the taxpayer.

Taxpayers under IRS audit also encounter paperwork burdens. Taxpayers receive multiple requests for the same information and married taxpayers receive two copies of certain information requests even though they file joint tax returns. Problems are not limited to audits. Taxpayers who participate in Offers in Compromise are often asked to resubmit the same information multiple times.

IRS communications could be vastly improved if a two-way system of communication via email were implemented as a communication channel. Email would facilitate faster responses to taxpayer inquiries and would be an efficient method for taxpayers to contact the IRS.

Another area in need of change is record retention. Currently, taxpayers are advised to keep copies of original tax returns for at least six years while tax preparers are required to keep copies of client returns for three years. This burden is further compounded by the fact that audit issues can cause the need for information to be retained from earlier periods. Approximately 170 million tax returns of various types are filed each year. Complying with the requested guidelines, assuming one return would be five pages in length (a very conservative estimate), would result in the need to store 8 billion pieces of paper! A more practical approach would be to place the burden of storage on the IRS since they already retain the information anyway.

Paperwork burdens have also been caused by the sheer complexity of the tax code. While there is hope that the Presidential Task Force will make proposals for simplification, there is much to be done in the interim. While the time I have to speak is limited, there is much more that could be communicated on this topic. I have only been able to speak to a few of the more pressing issues.

Thank you for your time and consideration of my comments. Chairwoman Miller and members of the Subcommittee, I look forward to our dialog and your questions on this issue.

Ms. MILLER. Thank you very much. I appreciate that. I actually was going to ask you all whether or not you thought the PRA was actually working, and in your comments you said it had failed its purpose. So I assume, Mr. Gray, you do not think it is working well. I would ask you to talk about that a little bit more, and to the other two panelists as well, what is your thought about the practical reality.

Mr. STEINBERG. As a practitioner, the PRA is not working at all. When people come in to have their taxes done, they have no idea really what the tax law is. I know that the Commissioner spoke about the increase in electronic filing. I will tell you that as someone who does electronic filing for my clients, the issue is not electronic filing. The issue is understanding the tax law.

I had three cases this past tax season where people were using off-the-shelf software to try to do their own taxes. And because of the complexity of the tax law, they were not able to complete their taxes using this off-the-shelf software and therefore, they came to my office and asked for help.

So here again, even though they went to the literature, such as in the cases involved, the incentive stock options that were cashed in, which is a major problem, because of the taxability of the incentive stock options, the tax law was so confusing to them, they did not know how to correctly place it on the form. What happened was that they wound up, or they thought they were going to wind up paying a great deal of tax. While in understanding the tax law as I do, they wound up not paying any tax, because tax had already been taken out of their compensation for the incentive stock options.

There was another one where an individual did not understand the laws regarding depreciating or amortizing a franchise fee. So he wanted to deduct the entire franchise fee, and all of a sudden he was getting back this huge refund. He came to me and said, no, this can't be right. I said, you're correct, you have to amortize the franchise fee. And here again, this is something where the complexity of the tax law, even though there is off-the-shelf software, that's not the panacea. That is only a tool. It is the understanding of the tax law that actually helps the taxpayer. From my perspective, every time Congress passes a new tax law, it's called the Tax Preparer Full Employment Act. [Laughter.]

Only for the simple reason that the complexity gets greater and greater. And the Commissioner had the volume of the new Jobs Act for 2004, one of the major problems that happened with that was that the law was passed in October. Tax season begins, for all intents and purposes, not in January, but February 1st, and we have until April 15th, unless we file extensions, to get all the information in.

In many cases, the IRS was incapable of answering some of the questions that we had. They said, well, we'll deal with it later, because of the amount of time between the passage of the tax law to get the new forms ready as of January 1st. A very inconsiderate move, in my opinion, by Congress to force the IRS into this untenable situation.

So the Paperwork Reduction Act, Madam Chairwoman, to answer your question specifically, is not working.

Ms. MILLER. Mr. Hall, do you have any better news than that?

Mr. HALL. Thank you. Well, I think I do. We will see. I believe the PRA has had a beneficial impact. I think back originally, the goal set by the OMB for the act was a 5 percent to 10 percent reduction in the burden on taxpayers. I think from a scorekeeping standpoint, if that is the standard, you have to conclude that the act has failed. I do not think that level of reduction has occurred.

But I think a lot of times, we like to talk in terms of reducing the rate of increase. I think looking backward, which is also easy to do, where we would be today without the Paperwork Reduction Act might be a very scary thing. I think one of the issues is that perhaps the IRS in its ability to forego some of the review requirements of OIRA, such as OSHA and EPA has, and that the OIRA reviews draft legislation, draft changes to make sure it meets cost benefit analysis, make sure it meets Paperwork Reduction Act, those things kind of help keep those in check. The IRS is not subject to those rules.

So in evaluating just the impact on the IRS of PRA, it is probably more devastating of a failure or of a lack to reach that original goal than looking at the act as a whole. Because in some of the other agencies, again, such as OSHA and EPA, I think there has been a tremendous benefit.

A few changes, perhaps even if possible having the IRS come under that advance review process. Five years from now we might have a different answer as to the success of that act. But I do believe the act has had a positive impact over the last 25 years.

Ms. MILLER. Thank you. Mr. Gray.

Mr. GRAY. Actually, I will go back and try to divide into two areas. I think to show how the act is not working, first is in the paper side. For example, I actually work with Michael Chessman's office for burden reduction on the K-1s that the Commissioner mentioned. That was effective, but that was in one area.

But when you go global and look at all the laws and all the changes, it is not just Congress, not just the IRS, but it is also our court system. Because I go across the country teaching, and I have to watch because in one circuit the case is one way and it's different in another.

Well, if you go to prepare the return it has to be prepared differently. So we really have to look at the big rule.

But the other thing I would like to talk about on burden reduction I think could be very effective, dollars spent. Mr. Lynch, your questions on the closing of the walk-ins and so on, sometimes you have to do what you have to do in a budget. But I think there is a real opportunity with the IRS working with outreach groups. I am not talking about offshoring, I am talking about practitioner groups. For example, in our area, I have a staff person that has worked with VIDA locally.

So I think what you have to do is look at people-wise. You look at these outside groups to say, how can we partner. But it has to be a coordinated effort from the national, so we can be communicating the same information.

The other thing you have to look at is when we get over in technology. We are in a new world. I mentioned it briefly in my talk, but to really have an impact, I believe, it is one thing to criticize,

but a critique has, I believe, some good comments, maybe ideas that work. I think what we have to look at is once an item or an event goes electronic, then if we are going to say, let's e-file, and we e-file everything we can in our office, if we are going to e-file that, then to reduce burden, it should be to the point where we have an electronic option communication back. It's not for all taxpayers, but you have to start somewhere. Cell phones at one point in time nobody had, and it is amazing how if it is easy and transparent, it becomes just another tool you do not think about.

So I think it is really important to have a business plan or a business model to look at the e-systems, the e-world, whatever you want to call it. But it is a two-way street. I think that is how we can reduce it greatly.

Ms. MILLER. Thank you, gentlemen. I will recognize the Ranking Member, Representative Lynch.

Mr. LYNCH. Thank you.

Just a couple of things. It is sort of counter-intuitive, but I heard the American Jobs Creation Act of 2004 referred to here, and I believe the Commissioner mentioned it in the earlier panel. Ironically, that was a bill that was supported very strongly and initiated by President Bush, who is, I think, probably the high priest of paper reduction in terms of trying to reduce the burden on taxpayers. He is really out there in front.

So here is the President, and the impetus for a lot of the Job Creation Act support was within the business community, quite frankly. That is who I heard from in my district. So we have people who are on the one hand complaining about the increases in complexity and the additions of, in this one act, 174 revisions or additions to tax products by the time that act is fully implemented. So they are asking for the changes and then complaining about the changes.

So it is counter-intuitive that not everything is just being self-generated by Congress. We are responding to the small business community and the larger business community as well, and this is something that we are working with, with the Republicans and Democrats together. But the bottom line is to create those exceptions and to create that relief, it requires additions to the Tax Code.

I am just wondering if, as I said to the other panelists, is it the model itself that we need to move away from? Can we realistically accomplish what we are trying to do here, notwithstanding the great improvements that have come in terms of technology? Do we have to look at a more simplified, although perhaps more blunt, instrument of taxation, the whole model? I would like to hear from all three, please.

Mr. HALL. Well, I think that as has been heard several times today, I think there is a magic bullet out there which is overall simplification of the Tax Code. I think that will answer a lot of the questions. Obviously there are a bunch of levels of compromise involved in that.

I think the thing from a small business standpoint that is very encouraging for me is to see the IRS making changes such as those Mr. Everson mentioned today, changing the threshold for 941 payroll tax limits, changing the reporting requirement from quarterly reporting requirement to annual reporting, simplification of the K-

1 form. Those are all steps that do not require an act of Congress to change the Tax Code, but have a tremendous impact on small business.

At some point, though, you get to the point to where each time you do a simplification, then you do have a period of time where small business taxpayers have to get up to speed on the change. So in the first year of change, it can even be more cumbersome for them because it is something that they are not used to. So they have to go back to instruction forms, go back to literature, go back to an online research vehicle to figure out how to use this new tax break or this new reporting form.

But over time, I think those changes have a tremendous positive impact. I think that goes back to my comments about the positive impact of the PRA in general. If you look at a specific point in time, do we have a system now that is manageable, that is not difficult, that is not cumbersome, I think the answer is no. But without the efforts that have been expended, would it be much worse today? I think the answer to that is yes.

I certainly am in favor of a more simplified and less complex Tax Code. But again, that is very easy to stand up and say, let's just simplify things. There are many steps involved in that.

Mr. STEINBERG. I would like to just add to what Mr. Hall has stated. Tax simplification is really the answer. If you want compliance, which is the goal of the Internal Revenue Service, to bring in revenue, by simplifying the Tax Code structure, you will reduce the burden. Since small business, Madam Chairwoman, as you stated in your opening remarks, shares disproportionately in the burden of compliance and since small business makes up 90 percent or more of all the businesses in this country, you will have economic growth the likes of which this country has not seen, because the resources can be reallocated to job growth and entrepreneurship. What better way to grow the economy, which the intended effect would be greater income to the Government?

So why not go for simplification where the intended consequence will be a fairer tax system, greater compliance and everyone paying their proper amount to the Government to help run the \$2 trillion economy?

Mr. LYNCH. The question was not whether or not we should have simplification, just whether this process, where the business community comes and asks us to make revisions and then there is an increase, as you saw, in that one bill, one bill alone, 174 revisions and additions.

Mr. STEINBERG. Congressman Lynch, any time there is a dialog between the public and Congress, it is only beneficial. Because you hear from us that are actually out there with the taxpayers, with the small business people, actually doing the work day to day. Therefore, as I stated, any communication which you receive from us, whether it be written or whether it be oral or whether it be just coming into your office as a member of a particular group. It is important that Members of Congress understand the depth and breadth of the issue of this and therefore the more communication, the better it is.

Mr. LYNCH. OK. All I'm saying is that act, the Job Creation Act of 2004 was us listening and us responding to the business commu-

nity. Now, because we responded in the way that we did, we are hearing complaints from the same business community that the tax laws have become more complex, which they requested several months ago. That's all I'm saying, it's a conundrum.

Mr. STEINBERG. Right. But Congressman Lynch, in 1986, when President Reagan had signed the Tax Reform Bill at that point in time, that drastically reduced burden and it simplified the Tax Code structure. From 1986 through 2004, it has grown disproportionately burdensome—

Mr. LYNCH. I agree.

Mr. STEINBERG [continuing]. Both to the individual and to small business.

Mr. LYNCH. I agree.

Mr. GRAY. I think that simplification itself, as we all know, is the Achilles heel to the complication. I think that when small business comes and says, we need this and this, maybe you step back and look and say, well, instead of throwing the whole thing out the window, why don't we take an activity like passive activities, which again 20 years ago was very critical, it stopped what was a big problem, but now it's filtered over into middle class America, people making under \$100,000. AMT started out to say, these corporations are going to pay something. And now it gets to a person making into \$100,000 with a family can end up in AMT.

So maybe you step back and say, yes, it is OK for us to come forward, small business, here are the ideas. But maybe there are some areas of law, credits is another one, it is called, maybe there needs to be a step-back and say, let's just take this whole area, yank it and put something else back in. Because if you change everything, then what happens, my theory a minute ago about the cell phone, everybody using them now, if you changed the technology and they had to do something different, what happens is the learning curve goes extremely high, non-compliance goes right with it.

So I think in the best interests of the tax system, maybe instead of fine tuning, you need to do some retuning. Throw some of those keys out and say we need something different. This was good for a time, but it has outgrown its need.

Mr. LYNCH. Thank you. Thank you, Madam Chairwoman.

Ms. MILLER. Thank you very much. I think we are all anxiously awaiting, the entire Nation anxiously awaiting the end of July when the President's tax simplification committee, we use that term, we cannot use the term reform, if we talk about tax reform we are going to get another one of those 5 pound books. But tax simplification, when they actually do make the recommendations, I think there will be a great amount of interest in that, particularly when you contemplate the fact that people estimate, guesstimate, whatever benchmark they are using, that the cost of compliance annually for taxpayers in our Nation, just to fill their forms out, is about \$225 billion. It really is rather staggering.

But I think sometimes in Government, things really never change. I often think, I was thinking about this actually when we were putting this hearing together, about paperwork reduction. My dad is an aeronautical engineer. He is in his 80's now, but he worked down at Redstone with Werner von Braun, which he said

were very exciting times, they used to set off the rockets. He said once the Government got involved, they never would let them set up a rocket until the weight of the paperwork equaled the weight of the rocket. [Laughter.]

So there has been, as they say, some things never change.

I certainly appreciate all of you attending today. You have given us some extremely specific recommendations about the kinds of changes that we need to look at here and I am certain that the committee staff has taken very good notes about many of these things. We certainly will be working with the Internal Revenue Service and some of the other agencies as well, but particularly with the Internal Revenue Service, with your recommendations to see about legislative changes, if that is necessary. Certainly I think we could promulgate some rules and the kinds of tools we need to give them to help our entire Nation comply with the existing Code as we look forward.

We appreciate all of your time and your traveling to Washington for our committee hearing. It has been very, very interesting. Thank you so much.

[Whereupon, at 3:30, the subcommittee was adjourned.]

[Additional information submitted for the hearing record follows:

TOM DAVIS, VIRGINIA
CHAIRMAN

CHRISTOPHER SHAYS, CONNECTICUT
DAN BURTON, INDIANA
ILEANA ROS-LEHTINEN, FLORIDA
JOHN M. McHUGH, NEW YORK
JOHN L. MICA, FLORIDA
OLG. OUTKROCHT, MINNESOTA
MARC E. KOEHLER, INDIANA
STEVEN C. LATOURETTE, OHIO
TODD RUSSELL, PLATEAU PENNSYLVANIA
CHRIS CANNON, UTAH
JOHN J. DUNCAN, JR., TENNESSEE
CANDICE MILLER, MICHIGAN
MICHAEL R. TURNER, OHIO
GARRELL ISAAC, CALIFORNIA
VIRGINIA BROWN-WHITE, FLORIDA
JON C. PORTER, NEVADA
KENNY MARCHANT, TEXAS
LYNN A. WESTMORELAND, GEORGIA
PATRICK T. McHENRY, NORTH CAROLINA
CHARLES W. DENT, PENNSYLVANIA
VIRGINIA FOXX, NORTH CAROLINA

ONE HUNDRED NINTH CONGRESS

Congress of the United States

House of Representatives

COMMITTEE ON GOVERNMENT REFORM

2157 RAYBURN HOUSE OFFICE BUILDING

WASHINGTON, DC 20515-6143

MAJORITY (202) 225-6074
FACSIMILE (202) 225-5974
MINORITY (202) 225-5551
TTY (202) 225-6862
<http://reform.house.gov>

HENRY A. WAXMAN, CALIFORNIA
RANKING MINORITY MEMBER

TOM LANTOS, CALIFORNIA
MAJOR R. OWENS, NEW YORK
EDOLPHUS TOWNE, NEW YORK
PAUL E. KANZISBERG, PENNSYLVANIA
CANDLYN B. MALONEY, NEW YORK
ELIJAH E. CORMINGS, MARYLAND
DENNIS J. KUCINICH, OHIO
DANNY K. DAVIS, ILLINOIS
WM. LACY CLAY, MISSOURI
DANIE E. WATSON, CALIFORNIA
STEPHEN F. LYNCH, MASSACHUSETTS
CHRIS VAN HOLLEN, MARYLAND
LINDA T. SANCHEZ, CALIFORNIA
C. A. DUTCH RUPPERSBERGER, MARYLAND
BRIAN HIGGINS, NEW YORK
ELEANOR HOLMES NORTON, DISTRICT OF COLUMBIA

BERNARD SANDERS, VERMONT,
INDEPENDENT

June 3, 2005

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Commissioner Everson:

I would like to take this opportunity to thank you for appearing before our Subcommittee on May 25, 2005, in our hearing entitled, "Less is More: The Increasing Burden of Taxpayer Paperwork." Because of time constraints at the hearing, I am enclosing the following questions for your reply to be included in our record.

Please hand-deliver the agency's response to the Subcommittee majority staff in B-373B Rayburn House Office Building and the minority staff in B-350A Rayburn House Office Building no later than 5 p.m. on Friday, July 1, 2005. If you have any questions about this request, please contact Dena Kozanas at 225-4407. Thank you for your attention to this matter.

Sincerely,

Candice S. Miller

Candice S. Miller
Chairman
Subcommittee on Regulatory Affairs

Enclosure

cc: The Honorable Tom Davis
The Honorable Stephen F. Lynch

1.) Paperwork Reduction Act:

- (a.) In the last two years, how many new proposed PRA collections did IRS program officers submit to the Treasury Chief Information Officer (CIO) for review prior to going to OMB for approval, and how many of these collections reviewed resulted in a lowering of the burden hours from the levels originally proposed by the IRS program officer?
- (b.) Since both the governmentwide and IRS paperwork burden has only steadily increased since the passage of the PRA, what recommendations would you offer to modify the PRA?

2.) Role of Tax Code:

- (a.) In your testimony, you often referred to the complex tax code as a major reason for why the IRS had to initiate certain information collections. For information collections that resulted in burden increases that IRS attributed to "statutory requirements," please describe the extent to which those increases are actually mandated by those statutes, and in those cases, whether changes in those statutes could reduce burden without adversely affecting program performance.
- (b.) If, in your opinion, the tax code is becoming increasingly complex and adversely affects the work of the IRS in terms of burden reduction measures, what would you recommend Congress do – in conjunction with the IRS – to reduce paperwork burden on the taxpayer?
- (c.) Similarly to Question 2b, if Congress were to give the IRS more authority and flexibility in administering tax laws (e.g., setting thresholds and income levels for reporting), would this likely result in a substantial reduction in paperwork burden?

3.) Methodology: Since 1997, the IRS has been in the process of reviewing its burden reduction model. Please explain (i) why it has taken so long to find a new methodology, and (ii) how will improving the way burden is calculated reduce the actual burden felt by the taxpayer.

4.) Calculating Burden:

- (a.) Please describe the extent to which the burden reductions and increases IRS attributed to "adjustments" were driven by agency reestimates of burden (which do not affect the actual burden felt by the American public) or by changes in the number of people responding to an information collection that were out of the control of the agency.
- (b.) Please describe the extent to which burden reductions and increases IRS attributed to "program changes" and the nature of the process in which such initiatives were derived.

5.) Electronic Initiatives:

(a.) In your testimony, you stated that roughly 67 million tax returns have been filed this tax season. If more taxpayers are using software or "Free File", what effect, if any, has this had on IRS' estimate of taxpayer burden hours?

(b.) Technological advancements seem to be a crucial part of reducing taxpayer burden. Besides E-filing, what other technological advancements is the IRS considering or sees on the horizon to achieve such reductions and, what if anything, can Congress do to help?

6.) Form Management:

(a.) Please state and describe what three tax forms OTBR considers as having the greatest potential for paperwork burden reduction and why.

(b.) In your testimony, you mentioned that one area of your burden reduction initiatives involves filing thresholds. For example, you mentioned that by administratively increasing the threshold for Form 1040EZ and Form 1040A from \$50,000 to \$100,000, the IRS was able to decrease taxpayer burden by more than 5 million hours. Please describe which other tax forms the IRS can administratively increase thresholds, meaning forms that do not require statutory authority to do so.

7.) Citizen Participation: Over the years, the Taxpayer Advisory Panel has come up with some innovative solutions to decreasing taxpayer burden. Please explain (i) what role focus groups and citizen groups play in IRS reform, and (ii) what recommendations you have adopted from these groups into your burden reduction initiatives.

1.) Paperwork Reduction Act:

(a.) In the last two years, how many new proposed PRA collections did IRS program officers submit to the Treasury Chief Information Officer (CIO) for review prior to going to OMB for approval, and how many of these collections reviewed resulted in a lowering of the burden hours from the levels originally proposed by the IRS program officer?

We submit all new proposed collections to the Treasury Chief Information Officer (CIO) prior to going to OMB for approval. From the period June 1, 2003 through May 31, 2005, IRS has submitted 75 new collections. None of these collections resulted in a lowering of the burden hours from the levels originally proposed by the IRS program officer.

(b.) Since both the government wide and IRS paperwork burden has only steadily increased since the passage of the PRA, what recommendations would you offer to modify the PRA?

The IRS has no recommendations to change the PRA. Currently, the IRS has appropriate and efficient procedures in place for submitting information collection requests to OMB. Treasury and IRS staff work cooperatively and collaboratively with OMB staff on PRA matters. Many of IRS' large burden information collections have been in place for decades and OMB has reviewed them numerous times. Many issues concerning burden associated with them have been resolved through previous OMB reviews resulting from PRA approval requests. Usually, major changes are required by statute, however, all changes are reviewed and have gone through a rigorous process within Treasury and IRS before submission to OMB.

2.) Role of Tax Code:

(a.) In your testimony, you often referred to the complex tax code as a major reason for why the IRS had to initiate certain information collections. For information collections that resulted in burden increases that IRS attributed to "statutory requirements," please describe the extent to which those increases are actually mandated by those statutes, and in those cases, whether changes in those statutes could reduce burden without adversely affecting program performance.

Below are examples of changes we made to tax forms to implement statutory requirements for reporting information to the IRS. Changes to the applicable

statutes could be made to reduce or eliminate reporting requirements and related burden.

1. Line 28 was added to Form 1040 to reflect the deduction for health savings accounts by PL 108-173, Act 1201, IRC 223. The addition of this line resulted in an increase in burden of 7.9 million hours.

2. Lines and words were added to Form 1040A, its schedules, and instructions by the Jobs and Growth Tax Reconciliation Act of 2003 (PL 108-27). These changes resulted in an increase to burden of 5.8 million hours.

3. Changes made to the Form 1041, its schedules, and instructions by adding and deleting lines and Code references, and adding 3 worksheets due to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27) resulted in an increase to burden of 12.3 million hours.

4. Changes made to Form 1065, its schedules, and instructions by adding and deleting lines and Code references due to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27) resulted in an increase to burden of 70.5 million hours.

5. Changes made to Form 1120S and its instructions by adding lines, Code references, and 1 worksheet due to the Job and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27) resulted in an increase to burden of 6.3 million hours.

6. Changes made to Form 4797 and instructions by adding lines and Code references due to the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27) resulted in an increase to burden of 3.6 million hours.

7. Regulation 152549-03 (regarding the Section 179 Deduction) was changed to reflect section 202 of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (PL 108-27) requiring increased recordkeeping and reporting. This change resulted in an increase to burden of 3 million hours.

8. The burden under Regulation 106177-97 Qualified State Tuition Program was changed due to the increased popularity of QTP accounts and the resulting recordkeeping. The Economic Growth and Tax Relief Reconciliation Act of 2001 provides a tax exemption

for earnings from QTP accounts when distributions are used to pay education expenses. This change has increased the popularity of QTPS and has increased the recordkeeping burden by 3.6 million hours.

9. IRS Restructuring and Reform Act of 1998 (PL 105-206) resulted in the creation of new Form 8453-S, S Corporation Declaration and Signature for Electronic Filing. The burden associated with this form is 17.5 million hours.

(b.) If, in your opinion, the tax code is becoming increasingly complex and adversely affects the work of the IRS in terms of burden reduction measures, what would you recommend Congress do – in conjunction with the IRS – to reduce paperwork burden on the taxpayer?

Tax administration comprises approximately eighty percent of the overall paperwork burden imposed by the federal government. But, that number can be somewhat misleading because much of the burden is the result of action taken by the IRS that is necessary to implement legislation. The IRS creates forms that enable taxpayers to comply with the law. A good analogy is that the forms are a bridge between taxpayers and the tax law, enabling citizens to comply in a consistent manner. That being said, we are committed to eliminating unnecessary burden by making our forms, schedules, publications, processes, procedures, and communications as clear and simple to understand as possible. Note that a significant part of a businesses' paperwork burden is associated with recordkeeping and financial requirements inherent in conforming to good business practices, regardless of tax-reporting requirements. When we measure the burden from taxes, following PRA rules, we do not include the foundational burden that would exist without taxes.

(c.) Similarly to Question 2b, if Congress were to give the IRS more authority and flexibility in administering tax laws (e.g., setting thresholds and income levels for reporting), would this likely result in a substantial reduction in paperwork burden?

Yes. In many cases, IRS in conjunction with the Treasury Department does have administrative discretion to set certain reporting thresholds. IRS does use that administrative authority to reduce burden consistent with compliance needs. For example, the threshold for requiring taxpayers to list the payors of interest and dividend income has been increased from \$400 to \$1,500. If the IRS had

additional administrative discretion, it could use data from returns filed, audits, and matching programs to determine what thresholds and income levels present the best opportunities for reducing paperwork burden. The data could be used to identify gaps in compliance that could be addressed by statutory changes, creating a balance between reporting requirements and compliance checks.

3.) Methodology:

Since 1997, the IRS has been in the process of reviewing its burden reduction model. Please explain (i) why it has taken so long to find a new methodology, and (ii) how will improving the way burden is calculated reduce the actual burden felt by the taxpayer.

(i) IRS set out to examine completely the possible methods of estimating both current taxpayer burdens as well as how taxpayer burden might be estimated if various hypothetical situations that might represent changes in taxpayer demographics over time, administrative changes, and legislative changes to the tax system. The goal was to develop improved – and hopefully more accurate – methods of estimating taxpayer burdens in a consistent manner across all federal taxes.

A Working Group from the Office of Tax Analysis in Treasury, the Office of Management and Budget, the Government Accountability Office, and IRS divisions has been working with the contractor for the project, IBM Business Consulting Services (formerly Price WaterhouseCoopers, and Price Waterhouse Coopers Consulting), to explore alternatives, to obtain data (both from taxpayers surveys and IRS administrative data), to try to understand the precise characteristics of taxpayers and the tax system that cause taxpayer burden, and develop and test econometric models that will be used to estimate and simulate taxpayer burden.

The individual taxpayer burden model (ITBM) that is now in testing and beginning to be used represents a new and innovative approach for measuring the burden on taxpayers of complying with the Tax Code. It is a micro simulation model based on taxpayer behavior measured through two surveys of taxpayers, and linked with IRS administrative data. Attributes related to complexity are built into the model's equations, and the ITBM includes options for obtaining estimates using forecasts of demographic and economic changes. The ITBM's detailed design based on careful use of data required extensive time for development, testing, modification, and retesting. The offsetting benefits are the variety of data available for tax administrators and policymakers, the ability to use the data to inform "what-if" scenarios, and, in general, its flexibility.

The ITBM is now reasonably complete, and the ITBM will be used to provide the estimates of taxpayer burden for individual taxpayers that will appear in the instruction booklets for the 1040 series of 2005 tax returns.

The ITBM is only the first phase of a project to estimate the taxpayer burden for all phases of the tax process and for all taxpayers. The ITBM covers the pre-filing and filing burden of individual taxpayers. The next phases of the project will develop consistent estimates of income tax burdens for small businesses, for employment taxes paid by small businesses, and for post-filing burdens. These phases have already started.

(ii) The new estimating methodology does not by itself affect taxpayer burden. However, by providing administrators and policy makers with information about the elements that cause excessive taxpayer burden, the ITBM will provide information that will enable them to make changes to minimize taxpayer burden consistent with other goals of tax policy.

4.) Calculating Burden:

(a.) Please describe the extent to which the burden reductions and increases IRS attributed to “adjustments” were driven by agency reestimates of burden (which do not affect the actual burden felt by the American public) or by changes in the number of people responding to an information collection that were out of the control of the agency.

The adjustments were all the result of updated information on the numbers of tax returns and tax forms submitted. The agency does not reestimate burden hours. It makes changes only when something affects the burden.

(b.) Please describe the extent to which burden reductions and increases IRS attributed to “program changes” and the nature of the process in which such initiatives were derived.

Primarily program changes are the result of legislation that affects tax forms. Program changes may also result from the major redesign of a form which may result from industry suggestions, employee ideas, meetings, focus groups, surveys, etc., as well as legislation.

5.) Electronic Initiatives:

(a.) In your testimony, you stated that roughly 67 million tax returns have been filed this tax season. If more taxpayers are using software or "Free File", what effect, if any, has this had on IRS' estimate of taxpayer burden hours?

The current methodology for estimating burden does not distinguish between paper filing and electronic filing. Our forthcoming burden model will allow us to make this distinction. It is important to note that some taxpayers will spend more time using software to prepare their return than if they had prepared it by hand.

(b.) Technological advancements seem to be a crucial part of reducing taxpayer burden. Besides E-filing, what other technological advancements is the IRS considering or sees on the horizon to achieve such reductions and, what if anything, can Congress do to help?

The IRS is in the process of enhancing and expanding its latest options of electronic products and services; E-Services, Modernized e-File and development of a Portal Business Strategy.

E-Services is a suite of Internet based products that allows tax professionals and payers to do businesses with the IRS electronically. These services include preparer tax identification number (PTIN) applications with instant delivery, individual TIN matching for third party payers, on-line registration for electronic E-Services, and on-line initiation of the electronic return originator application. Incentives are being offered for E-Services registration, such as on-line disclosure authorization, electronic account resolution, and transcript delivery system.

The IRS Portal Business Strategy articulates the vision for the delivery of information to and interaction with various IRS portal user communities. The implementation of an IRS enterprise portal will provide a single point of access to information, services & applications for all internal & external IRS user communities.

Part of the IRS Modernization effort, a new e-file infrastructure has been developed. The Modernized e-file (MeF) system supports Extensible Mark-Up Language (XML) and allow for form standardization between the different IRS e-file programs. The MeF program provides for the filing of tax and information returns electronically through the Electronic Management System (EMS) and the Internet via registered transmitters and electronic return originators and makes important improvements in filing and processing efficiency through system-wide integration and standardization.

6.) Form Management:

(a.) Please state and describe what three tax forms OTBR considers as having the greatest potential for paperwork burden reduction and why.

In general, the forms that impact on the largest number of taxpayers have the greatest potential for overall paperwork burden reduction. It is this opportunity to have a positive effect on filing burden that has led OTBR to focus attention on employment tax returns, including the recent revision of the Form 941 and the ongoing effort to revise the Form 940.

Besides looking at the areas with the most potential for burden reduction, OTBR uses its resources to focus on issues that taxpayers have brought to our attention, as well as areas which our research indicates taxpayers find problematic. For example, we have heard from many groups of taxpayers, practitioners, and Reporting Agents that they would like to have a better process to "correct" errors on their employment tax returns. In response, OTBR is investigating the feasibility of developing a Form 94X (similar to the Form 1040X), that taxpayers could use to amend their employment tax returns. In addition, OTBR is looking at revising the Form W-4 because we have heard from taxpayers and employers that this form is difficult to understand and complete. OTBR also is starting to evaluate the possibility of simplifying the home office deduction.

(b.) In your testimony, you mentioned that one area of your burden reduction initiatives involves filing thresholds. For example, you mentioned that by administratively increasing the threshold for Form 1040EZ and Form 1040A from \$50,000 to \$100,000, the IRS was able to decrease taxpayer burden by more than 5 million hours. Please describe which other tax forms the IRS can administratively increase thresholds, meaning forms that do not require statutory authority to do so.

The IRS does not have a complete list of all of the discretionary thresholds and their burden implications. The identification of these thresholds in the Internal Revenue Code, regulations, and instructions would require a significant amount of resources which we believe are better spent on specific burden reduction efforts. During Fiscal Year 2006, OTBR plans to continue to devote some resources to evaluating the impact of changes to actionable thresholds (either current ones or ones that could be established). In addition, OTBR has asked practitioner groups to assist in identifying such thresholds for further analysis. It should be noted that the benefits of raising thresholds for the use of simpler tax forms may be offset by increased compliance problems. Such trade-offs need to be examined and weighed carefully on a case-by-case basis.

7.) Citizen Participation:

Over the years, the Taxpayer Advisory Panel has come up with some innovative solutions to decreasing taxpayer burden. Please explain (i) what role focus groups and citizen groups play in IRS reform, and (ii) what recommendations you have adopted from these groups into your burden reduction initiatives.

OTBR is a strong proponent of the Taxpayer Advocacy Panel (TAP). As the "business owner" of the TAP Small Business/Self Employed (SB/SE) Issue Committee, OTBR works with the TAP members on a regular basis – using them both as a focus group and as a sounding board for burden reduction initiatives. For example, earlier this year, the TAP SB/SE Issue Committee served as a focus group for our proposed changes to the extension process and forms. The Committee made valid and valuable observations, increased our awareness of taxpayers' concerns, and prepared us for the types of questions and comments that we could expect from outside stakeholders. They also provided process and wording suggestions.

In another example of their work with OTBR, in February 2005, the TAP Issue Committee members expressed a strong interest in contributing to the development of the 944 Program (Form 941 Annual File/Annual Pay). Their support for the removal of a "troublesome" line, requesting information that the Bureau of the Census had originally wanted on the form, was integral to the decision by Census to allow us to eliminate that line. As a result, the final Form 944 will be simpler, clearer, and less burdensome.

The TAP also assists us with their perspective and input on other types of issues. For example, they provided feedback to IRS Collection on a Collection Information Statement that is used by Revenue Officers to assess the financial condition of taxpayers with outstanding tax debts. Currently, they are providing suggestions for the wording of letters taxpayers receive telling them their tax returns were selected for examination. And, earlier this month, our Research Division conducted formal focus group interviews with the TAP members to help develop a comprehensive mail-out strategy for IRS form mailings.